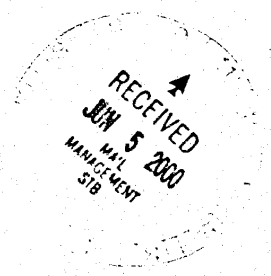


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BEFORE THE
SURFACE TRANSPORTATION BOARD

STB EX PARTE NO. 582 (SUB-NO. 1)

MAJOR RAIL CONSOLIDATION PROCEDURES



REPLY COMMENTS OF CSX, NORFOLK SOUTHERN AND UNION PACIFIC

Joint Compendium of Prior Railroad Submissions
on Forced Access and Bottleneck Rate Issues

VOLUME I

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**Joint Compendium of Prior Railroad Submissions
on Forced Access and Bottleneck Rate Issues**

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BEFORE THE
SURFACE TRANSPORTATION BOARD

STB EX PARTE NO. 582 (SUB-NO. 1)

MAJOR RAIL CONSOLIDATION PROCEDURES

REPLY COMMENTS OF CSX, NORFOLK SOUTHERN AND UNION PACIFIC

**Joint Compendium of Prior Railroad Submissions
on Forced Access and Bottleneck Rate Issues**

Pursuant to the Board's Advance Notice of Proposed Rulemaking ("ANPR") served March 31, 2000, CSX Corporation and CSX Transportation, Inc. (jointly "CSX"), Norfolk Southern Corporation and Norfolk Southern Railway Company (jointly "NS") and Union Pacific Corporation and Union Pacific Railroad Company (jointly "UP") are today filing separate reply comments addressed to the issue of proposed modifications to the Board's policies and rules governing proposed major rail consolidation transactions. Among other things, these individual submissions respond to the proposals, made by various parties in opening comments, that the Board should adopt revised merger rules that would authorize the Board to impose merger conditions to "promote" or "enhance" pre-existing rail-to-rail competition through various forced or open access requirements, such as mandatory switching in terminal areas, compulsory trackage rights to permit two-carrier rail service to solely served shippers, "bottleneck" rate requirements and similar measures.

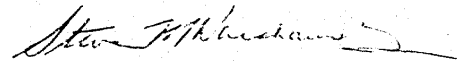
As CSX, NS and UP explain in their separate comments, these forced access proposals raise a number of legal and policy issues that the railroad industry and the Board have previously considered in other recent proceedings, notably including STB Ex Parte No. 575,

Review of Rail Access and Competition Issues, and STB Docket No. 41242, *et al.*, *Central Power & Light Co. v. Southern Pacific Transportation Co.* (served Dec. 31, 1996), *aff'd sub nom.*

MidAmerican Energy Co. v. STB, 169 F.3d 1099 (8th Cir.) *cert. denied*, 120 S. Ct. 372 (1999).

Because the issues -- and their proper analysis -- have not changed, CSX, NS and UP are tendering herewith for the convenience of the Board a compendium of the most relevant materials from the railroads' submissions in these two prior proceedings.

Respectfully submitted,



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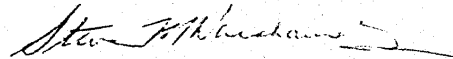
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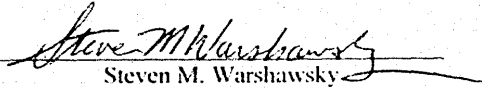
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DATED: June 5, 2000

CERTIFICATE OF SERVICE

I hereby certify that, on this 5th day of June, 2000, I served the foregoing "Reply Comments of CSX, Norfolk Southern and Union Pacific -- Joint Compendium of Prior Railroad Submissions on Forced Access and Bottleneck Rate Issues" (Volume I) by causing a copy thereof to be delivered by first-class mail, postage prepaid, to each of the persons listed on the Board's service list in this proceeding.


Steven M. Warshawsky

**BEFORE THE
SURFACE TRANSPORTATION BOARD**

STB Ex Parte No. 575

REVIEW OF RAIL ACCESS AND COMPETITION ISSUES

COMMENTS OF THE ASSOCIATION OF AMERICAN RAILROADS

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**BEFORE THE
SURFACE TRANSPORTATION BOARD**

STB EX PARTE NO. 575

REVIEW OF RAIL ACCESS AND COMPETITION ISSUES

**COMMENTS OF
THE ASSOCIATION OF AMERICAN RAILROADS**

INTRODUCTION AND SUMMARY

The Association of American Railroads submits these comments in response to the Board's request for comments served on February 20, 1998. AAR represents the interests of the nation's major railroads. Its members operate 77 percent of the route miles in the United States, employ 91 percent of rail employees and generate 93 percent of U.S. rail freight revenues.

AAR welcomes the opportunity to present its views on issues of competition and access in the rail industry. The opportunity arises at a time when the rail industry is under intense scrutiny as a result of the protracted and very serious service problems in portions of the western United States. These problems result from congestion caused by increased traffic and capacity constraints, not from a lack of competition. The industry is committed to solving the problems as quickly as possible and committed to making the additional capital investments in the rail infrastructure that will prevent these problems from recurring.

This review of access and competition in the rail industry also occurs at a time when certain shipper interests are calling for Congress to modify the existing scheme of economic regulation of railroads. Some specific legislative proposals have been announced and other proposed changes to the regulatory scheme have been discussed in the trade press. The

Board has not asked the parties to address specific legislative proposals that have been or might be made. We note that many of those proposals involve some sort of forced access to railroad lines. For the most part, AAR's comments address generically the impact of forced access on the nation's rail network and the effect of such forced access on the industry's revenues and its ability to make necessary investments in the rail infrastructure.

We note, as a threshold matter, that any regime of forced access would entail additional regulation beyond that which currently exists. It is legitimate to ask why shippers (who are not fully availing themselves of the remedies available under the current regulatory scheme) would be any happier with a different, more intrusive regulatory scheme. At a minimum, the costs to shippers (as well as railroads) of participating in a more elaborate regulatory scheme would surely increase. The costs and burdens of increased regulation were factors that led Congress to reject re-regulatory proposals when it enacted the ICC Termination Act in 1995.

The answer, apparently, is that shippers would be willing to participate in a more intrusive regulatory process if they were guaranteed that changes in the substantive standards would yield them net benefits in the form of rate reductions that exceed the costs of regulatory participation. A principal objective of those who seek re-regulation is to transfer revenues from the railroads to those shippers who currently pay higher rates than they likely would pay if they were served directly by two carriers. Whether directly or by implication, the existing regime of differential pricing is under attack. Certain shipper interests would dismantle it by having Congress and the Board manufacture some form of more pervasive head-to-head rail competition.

To AAR's knowledge, the proponents of forced access have never answered the question of how the railroads can be expected to sustain themselves as private enterprises if they operate under a regime of head-to-head competition that drives their prices down close to marginal costs. Some shippers would apparently contend that railroads could sustain rate reductions because they are already making too much money. The railroads, and the investment banking community to whom they must turn to raise capital, fail to understand how an industry which is not earning competitive returns on its assets and ranks in the bottom quartile of U.S. industries in terms of profitability can be viewed as making too much money. Existing law on the revenue adequacy issue supports the railroads' position.

But suppose the revenue adequacy standard were different and that under that different standard railroads were found to have achieved revenue adequacy under the existing scheme of differential pricing. How could that revenue adequacy be sustained under any regulatory scheme that gave all shippers access to two railroads? The economics are irrefutable. On many movements, direct rail-to-rail competition yields rates far lower than those needed on average to cover a railroad's total costs. We know of no way of moving toward or staying at a level of full cost recovery without heavy reliance on differential pricing. And unless there is meaningful progress toward or achievement of full cost recovery, railroads will not make necessary investments in rail infrastructure. Railroad managers will pursue their shareholders' interests by investing elsewhere in the economy where they can hope to earn a competitive return. Public sector funding would be required to keep the railroads viable.

In the post-Staggers era, railroads have been willing to commit virtually all of their free cash flow to investments in the rail infrastructure. It would be particularly dangerous to jeopardize this ability to invest at the present time when it appears that significantly more --

not less -- capital investment is needed to overcome the capacity constraints that the industry faces and to assure shippers the quality of service that they deserve. More capital investment is needed not only to increase the capacity of the rail infrastructure but also, as William Rennie and Allan Kaulbach of Mercer Consulting explain, to sustain the trend of increased railroad productivity.

The capacity constraints and attendant service problems that the industry faces do not reflect a lack of competition. Just the opposite is true. Spurred by a healthy U.S. economy and vigorous competition, rail traffic measured in revenue ton miles has grown some 25 percent since 1990 and rail rates have continued to fall. Traffic growth and declining rates plainly bespeak competition. It is widespread and effective. There is significant head-to-head competition between railroads. As Darius Gaskins explains, trucks continue to capture the vast preponderance of surface freight in the United States. Barges compete with railroads for much of the long-haul, heavy loading traffic that is particularly well suited to move by rail. Shippers are increasingly sophisticated in bringing product and geographic competition to bear on the railroads and in exerting competitive leverage through plant siting decisions and threats of build outs.

In those limited circumstances in which competitive abuse or market dominance can be demonstrated, the Board has sufficient tools and discretion under the existing regulatory scheme to address the harm and craft appropriate remedies. Those tools, such as the Board's market-based maximum rate standards and competitive access rules, were carefully developed to implement existing rail transportation policy. That policy strikes the right balance. It relies on competition in the marketplace to regulate price and service and it encourages the creation of additional competition through private investment and initiative. But that policy does not seek to

manufacture additional competition through regulatory intervention, as proponents of forced access would do.

The policies adopted by Congress and implemented by the Board have made the U.S. freight rail industry the envy of the world. Messrs. Rennie and Kaulbach explain that countries that have emulated the U.S. model have realized substantial gains in terms of increased productivity and reduced need for government subsidies. Other countries have experimented with various regimes of forced access to their railroad networks, but their experience has been unsatisfactory. As Drs. Kalt and Reishus explain, forced access in the rail industry raises a host of intractable problems, including the difficulty of designing a pricing scheme that provides for full cost recovery, the dissipation of economies of density and resultant increases in the cost of rail operations, and the problem of coordinating marketing, operating and investment decisions under a regime of open access.

Competition stemming from private initiatives yields efficiencies, as demonstrated by the tremendous growth in railroad productivity in the post-Staggers era. As Craig Rockey of the AAR explains, under Staggers railroads have shed unproductive assets and invested heavily in new productive assets. Productivity gains have been passed through to shippers, including those who are served by only one railroad, in the form of lower rates. Shippers will not benefit from artificial competition imposed through regulation. The existing regulatory scheme gives railroads the incentive to make the additional investments of private capital – not public funds – that will be needed to expand capacity, overcome current service problems and create a more efficient national rail network. It must be preserved.

AAR's Comments are supported by verified statements from individual railroad executives, economists and other transportation experts, and representatives of six major

financial institutions that supply capital to the railroads. Their testimony is briefly described below:

- **Chief Executive Officers of the Four Largest U.S. Railroads:** Robert D. Krebs, Chairman, President and CEO of The Burlington Northern and Santa Fe Railway Company, John W. Snow, Chairman, President and CEO of CSX Corporation, David R. Goode, Chairman, President and CEO of Norfolk Southern Corporation, and Richard K. Davidson, Chairman and CEO of Union Pacific Corporation and Chairman of Union Pacific Railroad Company, explain that the market-based regulation initiated with the Staggers Act has benefited both the railroads and the shipper community by promoting investment in railroad operations and that these benefits would be jeopardized by any attempt to re-regulate railroads through forced access.
- **Railroad Marketing, Financial and Strategic Planning Officers:** John Q. Anderson, Executive Vice President of Sales and Marketing for CSX Transportation, Inc. discusses the pervasive intermodal, geographic and product competition faced by the railroads and the need for adequate sources of capital to remain viable in the highly competitive transportation market. Michael J. Ward, Executive Vice President Finance for CSXT, discusses the financial performance of CSXT and its predecessor lines under the post-Staggers Act regime and describes the investments made possible by improved profitability. James W. McClellan, Vice President - Strategic Planning for Norfolk Southern, describes the economics of railroad networks, the benefits of keeping ownership and operating control of rail assets within vertically integrated firms, and the adverse implications of forced access.
- **Craig F. Rockey:** Mr. Rockey, Senior Assistant Vice President of the Association of American Railroads, presents detailed information showing the increased capital investments, increased productivity and declining rail rates that have resulted from the present regulatory system. He also explains that the railroads are not yet earning revenues sufficient to achieve full cost recovery and that to remain viable they need the flexibility of demand-based pricing to generate revenues necessary to make further infrastructure investments.
- **Joseph P. Kalt/David Reishus:** Professor Kalt, Ford Foundation Professor at the John F. Kennedy School of Government, Harvard University, and Mr. Reishus, President of The Economics Resource Group, Inc. (ERG), explain that the current market-based regulatory system has enabled the railroads to achieve economies of density and scope by allowing the market to determine where railroad resources

should be allocated. Under forced access, recovery of full costs would be essential to assure adequate capital investment, but it would be extremely difficult for regulators to design efficient access charges that accomplished this goal. Forced access would result in inefficiencies and increased costs because it would interfere with the ability of railroad management to coordinate operations and investment in a way that achieves optimal results for the enterprise as a whole.

- **William J. Rennie/Allan Kaulbach:** Messrs. Rennie and Kaulbach, Senior Vice Presidents of Mercer Management Consulting, Inc. (Mercer), have provided consulting services to railroads and governments worldwide. Their testimony describes the need for U.S. railroads to increase substantially their infrastructure investments in order to maintain efficient operations and the importance of an efficient U.S. rail system to the competitiveness of U.S. industries in the emerging global market. They also describe the lessons of open access from the actual experiences of several foreign countries. They explain that when governments attempt artificially to promote competition for railroad services through open access, the result is less competition and systems that are far more costly and cumbersome and far less efficient than the U.S. system.
- **Darius W. Gaskins, Jr.:** Dr. Gaskins is a partner at the transportation-based management consulting firm of Carlisle, Fagan, Gaskins & Wise, and was formerly Chairman of the ICC and a senior executive at Burlington Northern Railroad Company. His testimony describes the intense competition that railroads face from trucks. He explains that forced access would undermine the railroads in their competition with trucks because it would interfere with the ability of railroads to route traffic in efficient, single-line movements where they have proven to be most competitive. Dr. Gaskins also explains that the public benefits from a healthy railroad system because railroads are funded by private capital, unlike trucks that depend on public funds for highway infrastructure.
- **Investment Bankers and Securities Analyst:** The representatives of six major financial institutions – Chase Manhattan Bank, PaineWebber, Inc., Merrill Lynch, ABN AMRO North America, Inc., Credit Suisse First Boston Corporation, and Chase Securities Inc. – describe the harmful effects that forced access would have on the railroads' ability to raise capital for necessary infrastructure investments.

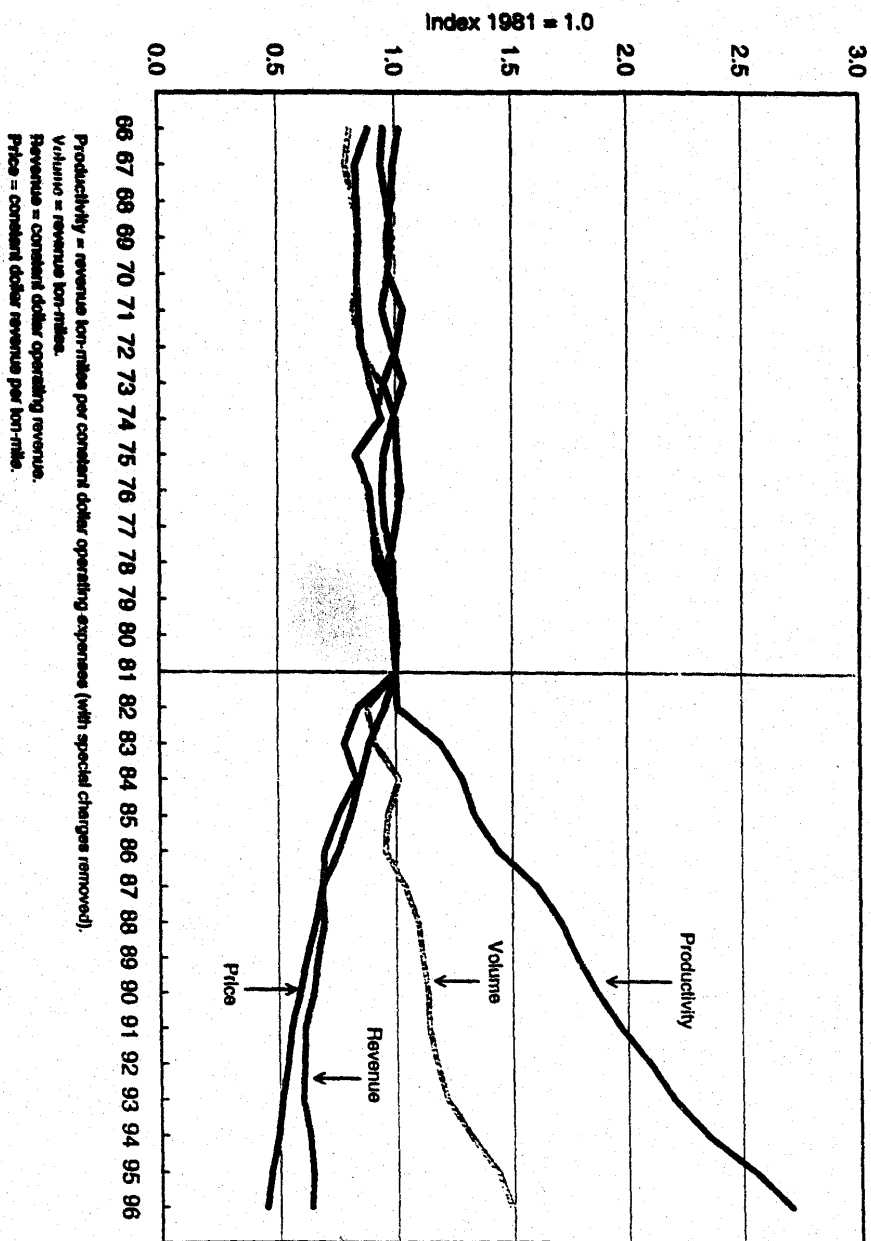
I. THE EXISTING STATUTORY SCHEME GIVES THE NATION'S RAILROADS THE ABILITY TO COMPETE VIGOROUSLY FOR THE TRANSPORTATION OF FREIGHT

The story of the rail industry's decline under the scheme of pervasive regulation in effect prior to the Staggers Rail Act of 1980 and its dramatic revitalization since Staggers is well known. *Rockey V.S.* at 4-6. In enacting the Staggers Act, Congress recognized that railroads faced intense competition from trucks and other modes for most categories of freight traffic but that prevailing regulation precluded railroads from earning revenues sufficient to maintain and replace the rail infrastructure and thus thwarted the industry's ability to compete. Survival of the railroad industry required a new regulatory scheme that allowed railroads to establish their own routes, tailor their rates to market conditions and differentiate rates on the basis of demand.¹

The reforms that Congress enacted have been an unqualified success. The pricing and routing freedoms of the Staggers Act have enabled railroads to rationalize their systems, reinvest in productive rail infrastructure, generate higher levels of service and dramatically increase productivity, resulting in lower rates for shippers. Figure 1, *Indicia of Railroad Performance Pre-and Post Staggers*, dramatically illustrates the results of deregulation. The data underlying Figure 1 and the significance of those data are discussed in more detail in the verified statement of Mr. Rocky.

¹ See H.R. Rep. No. 96-1035, at 35 (1979), reprinted in 1980 U.S.C.C.A.N. 3978, 3980; Cong. Rec. S15309 (daily ed. Oct. 29, 1979); H.R. Rep. No. 96-1035 at 121, reprinted in 1980 U.S.C.C.A.N. at 4153.

Figure 1
Class I Railroad Performance 1966 - 1996



The regulatory scheme devised by Congress relies on competition in the market place to govern rail rates and service. The experience since Staggers demonstrates that there is abundant competition in unregulated freight transportation markets which has allowed this congressional objective to be fulfilled.

Staggers allowed genuine rail-to-rail competition. The regulatory scheme prior to Staggers discouraged competition among rail carriers. Rates were set by rate bureaus, which recommended general rate increases that would apply across the board to all railroads and all commodities. Rates were equalized over all routes between a given origin/destination pair, without regard to differing costs. As a result, there was no incentive for railroads to compete. The Staggers Act reforms discontinued rate equalization, phased out general rate increases and gave the railroads freedom to price according to market demand and to operate over those routes that they found to be most efficient. As discussed in the statements of the railroad witnesses, direct rail-to-rail competition became a major source of pressure on rail rates and services after Staggers. For example, it is well documented that head-to-head competition between BN and CNW (now UP) in the Powder River Basin resulted in a dramatic reduction in rail rates for transportation of PRB coal, as those railroads competed vigorously for that market. Even at points served solely by one rail carrier, transload facilities and the possibility of build-outs to nearby rail competitors have been used effectively to hold down rail rates. *Anderson V.S.* at 12, 15-16; *Davidson V.S.* at 6.

Truck competition is pervasive and trucks continue to capture most surface freight. Despite the dramatic progress of the rail industry, trucks still command the lion's share of the overall surface freight transportation market and compete effectively with railroads for movements of every commodity. *Gaskins V.S.* at 2-6. The increasing trend for railroads to

participate in transloading operations, compete for intermodal traffic, and invest in the construction or expansion of intermodal facilities, as CSX and NS will do if the Conrail acquisition is approved, is further evidence of the intense competition and the need for railroads to find creative ways to compete for a share of this market. Ward V.S. at 13.

Just as railroads are seeking to convert truck traffic to intermodal and carload rail service, trucks today are transporting significant volumes of heavy bulk commodities that traditionally have been considered rail commodities. For example, where it was once considered impractical for trucks to move coal, a significant amount of the coal in the Appalachian coal fields begins as a truck movement. Anderson V.S. at 13. Similar truck-rail competition exists for coal movements in Utah. Other bulk commodities, such as soda ash likewise are transported by truck or in truck-rail movements.

Barges provide effective competition for the bulk commodities best suited for rail transport. Some shippers have located their facilities on navigable waterways. Others have the option to move their goods by truck or rail to navigable waterways to utilize barge competition for bulk commodities, including coal, chemicals and grain. For example, railroads compete with barges for transportation of coal from Appalachian coal mine origins. Anderson V.S. at 14-15. Barge currently is a significant competitive option for movement of lumber along the West Coast and there has been a recent announcement by Trailer Bridge, Inc. of a proposed new barge service along the East Coast from Jacksonville, FL to the New York/New Jersey area that is expected to pull cargo off highways and railroads in the East.² Ships on intracoastal

² Barges Could Lure Truck, Rail Cargo, J. Comm., Mar. 20, 1998.

waterways likewise play an important role in the transportation of many commodities, including chemicals.

Shippers exploit product and geographic competition with increasing ingenuity. For coal transportation to electric utilities, dispatching priority and wheeling are increasingly effective competitive constraints. As competition unfolds in the electric utility industry, coal-hauling railroads will necessarily be forced to compete with the cheapest source of system-wide generation or off-system purchased power. Competition also exists in the form of alternative mine sources and destinations and the substitution of other fuels.

Shippers of all commodities with multiple plants and facilities from which to supply their customers can take advantage of the geographical location of those facilities to increase their transportation options. Likewise, product users with multiple sources from which to obtain product can shop around for the best delivered price. The ability of companies to site plant expansions or new facilities at locations with access to multiple carriers also provides bargaining leverage in negotiating transportation prices. Anderson V.S. at 17, 19-21.

The introduction of new products and materials provides greater options for manufacturers and consumers. For example, the container industry can use glass, aluminum or plastic for most food and beverages. Less expensive imported steel is often used in place of domestic steel in construction projects. The availability of product and material substitutes affects rail transportation rates and volumes and provides effective competitive leverage to shippers. Anderson V.S. at 18; Davidson V.S. at 8.

Competition in the market place has resulted in steadily declining rail rates. As is shown in the STB's own recent analysis, which was released by the Board's Office of

Economics in February 1998, the average real rail rate had fallen 46.4 percent between 1982 and 1996. *Rockey V.S.* at 35.

Congress is well aware of the benefits of the competitive process initiated by the Staggers Act. In 1995, shipper groups presented many of the same proposals for re-regulation of railroads that are being raised today. In enacting the ICCTA, Congress appropriately rejected those proposals and concluded that the competitive process initiated by the Staggers Act should continue to work unfettered by new regulation. The Board itself has recognized that the competitive process unleashed by the Staggers Act has been one of the most significant public policy successes of this century.

II. RAILROAD MERGERS OVER THE PAST TWENTY YEARS HAVE RESULTED IN INTENSIFIED COMPETITION

Some shipper interests express concern about the effect of mergers in the rail industry, suggesting that the trend toward consolidation has gone too far and that the reduced number of carriers means there is less rail-to-rail competition. As a matter of economic analysis, this allegation simply does not hold up. The level of competition is not a function of the number of relatively large railroads in the nation as a whole. It is a function of the quality and effectiveness of competitive options in particular markets. The stronger railroads created through mergers in the post-Staggers era have enhanced competition.

A. The Mergers of the Past Twenty Years Have Been Procompetitive

The argument that railroad mergers have caused a reduction in competition ignores the fact that twenty years ago the United States rail network was largely balkanized into several dozen regional railroads. Long-haul, single-line movements were the exception rather

than the rule. Most traffic moved in interline service, with moves involving three or more carriers being quite common. The industry was plagued with excess capacity and few railroads were able to achieve any meaningful economies of density because of the declining traffic base and the multiplicity of routes under the prior regime of open routing.

The trend toward consolidation in the rail industry has been a market-driven effort to achieve cost savings through the creation of more efficient rail networks. *Kalt/Reishus V.S.* at 10. Railroads exhibit economies of density and scope. By increasing the volume (density) of traffic moving over the rail network, railroads are better able to cover their fixed costs. And by expanding the scope of their service offerings, railroads can improve their ability to recover common costs, such as the costs of rolling stock and terminal facilities. Accordingly, most railroad combinations of recent years have been predominantly vertical or end-to-end in nature, allowing the combined carriers to offer extended single-line service into new markets and attracting higher volumes of traffic to single-line routes.

The Board and its predecessor have recognized that vertical combinations are fundamentally pro-competitive. In the Burlington Northern/Santa Fe merger, for example, the ICC found that the expanded market coverage resulting from the creation of new single-line service would stimulate competition:

A commonly controlled BN/Santa Fe will encompass significantly more of the major western freight transportation markets than either BN or Santa Fe covers alone. Current customers of BN and Santa Fe will benefit from extended market coverage, which will result in new competition for other railroads, trucks, and water carriers, and, ultimately, improvements in service and/or decreases in rates. There are several significant markets in

which the consolidated system would provide new single-line service.³

The Board's predecessor also repeatedly rejected claims that vertical combinations of railroads would result in competitive harm, finding the allegations of such harm to be implausible and unsubstantiated.⁴ Instead, expanded rail networks, more efficient route structures and lower costs have allowed merged railroads to compete more effectively with one another and with trucks. Dr. Gaskins explains that railroads are better able to compete against trucks when they are able to offer single-line service "because rail performance improves when railroads have unified control of both the railroad infrastructure and the operation of the freight transportation using it. Split control – in the form of interline transportation – poses a variety of challenges that the railroads have had consistent difficulty addressing." Gaskins V.S. at 10.

B. The Reduced Number of Railroads Resulting from Mergers Does Not Equate to a Reduction in Competition

Those who play the numbers game tend to speak of the reduction in the number of Class I railroads. Currently there are nine Class I railroads.⁵ There will be eight if the pending Conrail control transaction is approved. Comparisons between the number of Class I carriers

³ Burlington Northern Inc. – Control and Merger – Santa Fe Pac. Corp., Finance Docket No. 32549, slip op. at 59 (ICC served Aug. 23, 1995) (BN/Santa Fe).

⁴ See, e.g., BN/Santa Fe, slip op. at 71; Union Pac. Corp. – Control – Missouri Pac. Corp., Western Pac., 366 I.C.C. 462, 538 (1982) (UP/MP/WP); see also Western Resources, Inc. v. STB, 109 F.3d 782, 787 (D.C. Cir. 1997); Seaboard Air Line R.R. – Merger – Atlantic Coast Line R.R. (Petition to Remove Traffic Protective Conditions), Finance Docket No. 21215 (Sub-No. 5), slip op. at 5 (I.C.C. served Mar. 27, 1997)

⁵ Burlington Northern Santa Fe, Conrail, CSXT, Grand Trunk Western, Illinois Central, Kansas City Southern, Norfolk Southern, Soo Line, and Union Pacific.

that exist today and the number that existed at any time prior to 1991 are misleading because the ICC changed the revenue threshold for determining Class I carrier status in 1991, raising it from \$96.1 million in annual operating income to \$250 million in annual operating income. If this standard had not been changed, there would be 16 carriers today that would meet the Class I standard.

And those who play the numbers game tend to ignore the other side of the coin. Based on 1996 data, which is the most recent available, 333 of the 553 freight railroads operating in the United States today were established in 1981 or more recently. The local and regional railroads created under deregulation account for 36,324 miles of road operated, approximately 21 percent of the industry total. In short, there is an increasing number of vigorous regional and shortline railroads who have "filled in the gaps" on the national railroad map.

But the reality is that neither the absolute number of railroads nor the number of railroads of a particular size is a true measure of the intensity of competition. Competition can only be assessed meaningfully with reference to particular markets and with reference to the strength of the competitive options available in those markets. This is precisely the inquiry that the Board and its predecessor have undertaken in individual merger proceedings. In doing so, they have adhered carefully to the statutory policy of preserving rail competition. As noted earlier, the agency has carefully scrutinized allegations of reduction in competition through vertical combinations of railroads and found them to be unsubstantiated. Allegations of reduced competition through horizontal overlap are a different story and the ICC and the Board have been vigilant in assuring that rail mergers do not result in significant competitive harm through horizontal overlap.

Certainly the most prominent illustration of the agency's role in preserving horizontal competition is the 1986 decision of the ICC denying the proposed combination of Southern Pacific and Santa Fe on the grounds that there would be substantial horizontal overlap between the two systems that would cause a reduction in competition. Other rail mergers that have been approved by the ICC or the Board in the post-Staggers era have all entailed careful scrutiny of horizontal effects, and the agency has not been reluctant to impose conditions to remedy competitive harms when the record has justified such relief. Indeed, the precedent that the agency will impose a remedy in so-called "two-to-one" situations is so well established that the applicants in recent control proceedings have taken proactive steps to eliminate such reductions in competition before submitting their applications for the agency's approval. In addition, commercial arrangements entered into between railroads in the context of settling disputes related to merger proceedings frequently have had the effect of expanding the competitive reach of the parties beyond that which existed prior to the transaction. In the Burlington Northern/Santa Fe merger for example, the applicants entered into a settlement agreement with Southern Pacific that not only provided for SP to receive trackage rights to remedy reductions in competition at certain points but also provided for new access for both SP and applicants to certain markets.

Although the number of very large railroads has been reduced, intramodal competition is stronger because the remaining large railroads are stronger and their market reach is greater. Economies of scope and density are conducive to the creation of railroads that can attract large volumes of traffic and have broad geographic reach. The nation is better served by having two strong rail networks with broad network coverage who compete with each other throughout the West or the East than with a patchwork quilt of regional railroads that face

limited intramodal competition within their "franchise" territories. The proof is in the numbers. Railroad mergers have not been accompanied by rising prices. Just the opposite has occurred. The Board is aware that this trend in declining prices has occurred even though the ICC often permitted the number of railroads offering service in a particular market to decrease to two:

Indeed [the ICC] approved mergers resulting in only two major railroads serving large portions of the East. The two railroads, CSX and NS, have competed effectively in these markets. As has been true for the nation's rail system as a whole since the Staggers Act, competitive pressures have been sufficient to spur railroads to enhance productivity by adopting efficient operating and management systems, and their costs have gone down each year because of significant productivity gains. Competitive pressures have ensured that the preponderance of those gains have been passed along to shippers in the form of lower rates and better and more responsive service.⁶

Rail mergers have been driven by the need to create more efficient rail networks. The process of actually achieving the efficiencies is obviously not foolproof, as the problems currently being experienced by Union Pacific attest. But, as the Board has recognized, the service problems in the West were not caused by the combination of UP and SP. Given SP's weakened financial and physical condition it was already vulnerable to the combined stresses of traffic growth and inadequate infrastructure. When the service crisis is past and the necessary investments in the rail infrastructure have been made, the full procompetitive effects of two strong rail networks in the West will be realized.

⁶ Union Pac. Corp. - Control and Merger - Southern Pac. Rail Corp., Finance Docket No. 32760, slip op. at 118 (served Aug. 12, 1996) (UP/SP).

III. THE CURRENT REGULATORY STRUCTURE HAS ALLOWED THE NATION'S RAILROADS TO BECOME MORE VIGOROUS COMPETITORS BY PROMOTING CAPITAL INVESTMENTS IN RAILROAD INFRASTRUCTURE

Railroading is a capital intensive business. The nation's railroads require about three times as much capital for each dollar of revenue generated as the average S&P Industrial company. Rockey V.S. at 7. Large capital expenditures are needed to maintain plant and equipment, to upgrade facilities as technology and markets change, and to expand capacity.

There was little doubt at the time of the Staggers Act that inadequate investment by the nation's railroads had been a major factor contributing to their poor financial health and unsatisfactory service. As Congress explained:

The simple fact of the matter is that the railroad industry is a capital-intensive industry which for decades has had inadequate earnings to maintain its plant and facilities at a level necessary to achieve improved services.⁷

The inadequacy of capital expenditures prior to the Staggers Act had fed upon itself -- lower investment led to lower quality service, which led to a decline in traffic volume and lower revenues that made further investment impossible.⁸ Mr. Rockey describes in his Verified Statement the problems generated by the deferred maintenance and delayed capital improvements that characterized the 1970s. Rockey V.S. at 4-6.

Deregulation under the Staggers Act has been highly successful in promoting reinvestment in railroad infrastructure. Even as railroads have shed unproductive assets through

⁷ Staggers Rail Act of 1980, H.R. Rep. No. 96-1430, at 95 (1980) ("Staggers Act Report").

⁸ *Id.*

abandonments and consolidations, they have invested in new productive assets. Capital investment by the nation's Class I railroads increased from under \$20,000 per track mile in 1983 to almost \$40,000 per track mile in 1996 in 1983 dollars. Rockey V.S. at 11-14 and Figure 1. The increase is far greater when expressed in nominal dollars. As Figure 1 to Mr. Rockey's Verified Statement demonstrates, much of that increase in investment has occurred in the last 5 years. Overall, new capital investment in roadway, structures and equipment by the nation's Class I railroads in 1996 alone was over \$6.1 billion, with an additional \$4.5 billion in roadway and structure maintenance expenditures. Rockey V.S. at 11-12.

This investment in the rail industry since the Staggers Act has made the nation's railroads stronger and more effective competitors. The expansion and improvement of intermodal yards and terminals, track improvements and clearing of tunnels to accommodate double-stack intermodal traffic have allowed the railroads to attract substantial traffic from trucks. Extensive investment in railroad infrastructure has permitted the exploitation of Powder River Basin coal reserves. Operations have been improved through massive expenditures in information and dispatching systems. The attached verified statements of AAR members describe these investments further:

- Robert Krebs describes the benefits that have flowed to shippers from BNSF's large capital expenditures on equipment and infrastructure in recent years and notes that BNSF expects to spend almost \$7 billion during the three year period 1996-1998 on infrastructure maintenance and expansion projects, including investments in new and rehabilitated tracks and yards and state-of-the-art information systems.
- Michael Ward notes that CSXT has purchased 845 new locomotives since 1989 alone, at a cost of \$1.2 billion. He describes the costly improvements made to several major traffic routes and discusses the ongoing investment by CSXT in information technology.

- David Goode describes the NS 1998 capital improvements budget of almost \$1 billion, including expenditures for track improvements, information systems and intermodal and bulk distribution facilities.
- Richard Davidson explains that while the burdens of pre-Staggers Act regulation led railroad owners to diversify rather than invest in rail operations, since the Staggers Act, the railroads now combined in the Union Pacific system have invested more than \$31 billion in 1997 dollars in their rail system.

These investments were made possible as the railroads' operating margins improved after the Staggers Act. Mr. Rockey demonstrates that the railroads are reinvesting most of their available cash flow in infrastructure. Rockey V.S. at 14-18. But even with the large and increasing reinvestment of available cash flow by the railroads, they continue to rely heavily on outside sources of capital. See Figure 2 to Rockey V.S. and the attached investment bankers and securities analyst verified statement. These investments have contributed to dramatic improvements in productivity and as the railroads become more productive, rates have declined across the board. Rockey V.S. at 18-38.

While their profitability has improved since passage of the Staggers Act, the railroads still do not generate a return on investment equal to their cost of capital. The nation's railroads rank third out of 180 U.S. industries in productivity improvements since 1979, but their return on equity remains in the bottom quartile of the industries examined by Fortune. Rockey V.S. at 27, 44. Investor confidence in the railroads has improved, but returns on railroad investments are still low compared to other industries.

Access to capital is more important than ever to the railroad industry for two reasons. First, as explained by Messrs. Rennie and Kaulbach, the railroads were able to increase their profitability since Staggers in the face of strong competition from trucks and declining rates only through increased productivity. Those productivity gains, however, were

achieved through measures that have largely been exhausted or through one-time events – as Messrs. Rennie and Kaulbach put it, by harvesting the “low-hanging fruit.”

Rennie/Kaulbach V.S. at 5-6. Future productivity gains will need to be “purchased” with additional, large-scale strategic infrastructure investments. Messrs. Rennie and Kaulbach estimate that the nation’s railroads will need to double their levels of capital investment over the next decade in order to remain viable. *Id.* at 6.

New investment is also needed to meet increasing shipper demand for transportation service. Rail traffic as measured by revenue ton-miles has increased by about 50% since 1980. Figure 14 to Rennie V.S. Part of this growth has been fueled by the increasing globalization of commerce and the resulting increase in demand for high-volume, long-haul transportation that is well suited to railroads. The railroad industry has reached the point where further significant traffic growth will not be possible without investments that expand capacity. Indeed, the concerns expressed by shippers over the current level of railroad service are the direct result of capacity constraints in the railroad network. The industry is as anxious as its shippers to resolve these problems, but improvements in service can only be made with further investments in tracks, structure and equipment.

The need for new infrastructure spending is widely acknowledged. The recent White Paper issued by the Railroad-Shipper Transportation Advisory Council stated that “today’s demand for rail capacity outstrips the available supply.”⁹ “Since Staggers, the number of total Road Miles Owned in the United States has been reduced by 36%, yet the total tonnage

⁹ White Paper, Railroad Shipper Transportation Advisory Council at 2 (Mar. 1998) (“RSTAC White Paper”).

has increased by 41%.¹⁰ Grain traffic has increased by 18% since 1991, coal traffic by 46%, chemicals by 26%, and intermodal by 42%.¹¹ With the growth in demand, "the system in many places has reached its operational capacity."¹²

Increasing demand for transportation is having an effect on all aspects of the nation's transportation system, not just the railroads. Trucks, which still dominate the surface transportation of freight, face capacity constraints of their own. Driver shortages persist and there continues to be political debate surrounding the public funding of increased highway capacity. The nation's port facilities also are finding themselves increasingly pressed for funds to accommodate an explosion in intermodal cargo traffic.¹³ It is clear that transportation capacity will have to increase as the economy expands. The railroads can contribute to meeting these increased capacity needs through private capital – unlike motor carriers that rely on public funding of highway construction and expansion – but only if the regulatory structure gives the railroads an incentive to make the necessary investments.

The Board has recognized that the recent service problems in the West are in large part a consequence of inadequate infrastructure and constraints on available capacity. In its February 17, 1998 decision in STB Service Order No. 1518, the Board stated that

the evidence shows that this [service] emergency was caused in large measure by a transportation infrastructure in and around Houston that is not adequately equipped to deal with natural surges in a growing economy. . . . To protect against future crises . . . the

¹⁰ Id. at 1.

¹¹ Id.

¹² Id.

¹³ See Rebuilding US Infrastructure to Cost Billions, J. Comm., Mar. 11, 1998.

physical plant in Houston will require major upgrading in order to meet the needs of shippers.¹⁴

As the Board noted, "It is well known that SP's physical plant in general was in a state of disrepair when UP took it over."¹⁵ Union Pacific has acknowledged that investments in infrastructure are needed and has taken measures to address these infrastructure needs.¹⁶ As Mr. Davidson states, "We are conducting a comprehensive analysis of the physical infrastructure needs of the Union Pacific system in the Gulf Coast area, and we are going to invest what it takes to meet those needs." Davidson V.S. at 3.

Since the service problems have been created in part by inadequate infrastructure, it would be a grave mistake to make regulatory changes now that discourage or inhibit necessary investment. Indeed, the Board rejected the forced access proposal of the Railroad Commission of Texas in Service Order No. 1518 precisely because that proposal would have had the effect of discouraging necessary investment. As the Board stated, "Government action that would discourage private investment in infrastructure without providing alternative funding would degrade rather than improve service, and plainly would be irresponsible."¹⁷

The Board also acknowledged in its February 25 Decision extending Service Order 1518 that adequate levels of infrastructure investment can be assured only if the railroads earn adequate revenues. Noting that there was a 71 percent growth in ton-miles on the SP system over the 10-year period ending in 1996, while revenue growth was only 18 percent, the

¹⁴ STB Service Order No. 1518 at 6 (Feb. 17, 1998) ("Feb. 17 Order").

¹⁵ *Id.* at 5.

¹⁶ Rail Service in the Western United States, STB Ex Parte No. 573 at 5 (served Feb. 25, 1998) ("Feb. 25 Order").

¹⁷ Feb. 17 Order at 7.

Board concluded "that this profitless growth contributed heavily to the inadequacy of SP's Houston area infrastructure because there were few funds available to invest in the infrastructure."¹⁸ In order to promote necessary investment in infrastructure, railroads must have the opportunity to earn competitive returns and to that end they need the pricing flexibility afforded by the present regulatory system.

IV. THE EFFICIENT AND COMPETITIVE RAIL NETWORK BROUGHT ABOUT BY THE CURRENT MARKET-BASED REGULATORY STRUCTURE GIVES U.S. INDUSTRIES A COMPETITIVE EDGE IN GLOBAL MARKETS

Global trade is becoming increasingly important to the U.S. economy. Exports as a percentage of the gross domestic product have increased over 50% since 1985, from 7.2% in 1985 to 11.9% in 1998. *Rennicke/Kaulbach V.S.* at 7. As global trade increases, the efficiency of U.S. railroads is becoming increasingly important to U.S. competitiveness, a development recognized by the Board in its decision approving the Alameda Corridor project. There, the Ports of Los Angeles and Long Beach were authorized to construct a 20-mile, multi-track rail corridor extending from the ports of Los Angeles and Long Beach into central Los Angeles. As the Board explained,

The fundamental purpose of the Alameda Rail Corridor project is to provide for more efficient rail freight transportation to and from the ports in order to accommodate and promote increased economic activity at the ports as the major West Coast and United States gateway to Asian and Pacific Region trading routes.¹⁹

¹⁸ Feb. 25 Order at 4-5 n.7.

¹⁹ Alameda Corridor Construction Application, Finance Docket No. 22830, at 4 (STB served May 13, 1996).

The Board acknowledged that extraordinary growth in traffic through the Ports of Los Angeles and Long Beach was expected as global trade becomes more important to the health of the U.S. economy:

The Ports have detailed the substantial increases in cargo they expect to handle over the next 25 years. In 1991, the Ports handled approximately 99 metric tons of cargo; by 2020, they expect to handle more than twice that amount. As a result of this anticipated growth in cargo, port-related train movements over rail lines serving the port area are expected to increase from the current average of 28 trains per day to an average of 73 trains per day in 2010 and 97 trains per day in 2020.²⁰

Efficient railroad transportation is critical to U.S. exporters of coal and grain.

Total U.S. coal exports are valued at \$3 to \$5 billion dollars per year in recent years. Over 80% of this coal is moved to port by rail. USDA recently estimated that 41% of grain exports in 1994-95 were carried to port by rail. In 1996, railroads delivered more than 350,000 carloads of grain to ports, with a value of more than \$5 billion. Railroads carried additional volumes of grain destined for the ports in interline movements with other transportation modes, such as barges. Rennie/Kaulbach V.S. at 7-9.

Railroads also handle an increasing amount of containerized traffic moving through U.S. ports. Intermodal service is one of the fastest growing segments of rail traffic, up over 40% since 1990. In 1997, railroads originated a total of 8.7 million trailers and containers in the United States, and it is estimated that 34% of this traffic is interlined with international steamship companies. This would represent a total of about 3 million units moving on the U.S. railroad system that is involved in offshore trade. Assuming an average value of \$40,000 per container, the value of this traffic is about \$120 billion. Rennie/Kaulbach V.S. at 8.

²⁰ Id. at 8.

Railroad transportation is also critically important to the success of NAFTA.

Canada and Mexico are the first and third largest trading partners of the United States. In 1996, the railroads carried goods valued at \$73 billion dollars in trade with these two countries.

Slightly more than half of this traffic consisted of motor vehicles (autos and trucks) and motor vehicle parts. Other important commodities carried by the railroads in this international trade with Canada and Mexico included paper, paperboard and wood pulp (\$5.6 billion); machinery (\$5.1 billion); metals and metal articles (\$4.4 billion) chemicals and fertilizers (\$4.1 billion); wood and wooden articles (\$4.0 billion); and plastics (\$2.5 billion). Id.

In short, U.S. industries are becoming more dependent on the railroad system as global trade becomes a more important part of the U.S. economy. The efficiency of the railroad system, promoted by the deregulatory policies established after the Staggers Act, contributes to U.S. competitiveness.

V. THE EXPERIENCE OF OTHER NATIONS HAS DEMONSTRATED THAT THE EXISTING REGULATORY SYSTEM IN THE UNITED STATES IS FAR SUPERIOR TO A REGIME OF FORCED ACCESS

It is not hyperbole to say that the U.S. freight railroad system is the envy of the world. U.S. freight rates are lower than freight rates throughout the developed world. See Figure 6 to Rennie/Kaulbach V.S. These low rates are the direct result of Congress' decision to let the market guide railroad decisions and the implementation by the ICC and the Board of a market-based regulatory system. Moreover, the low rates and high productivity of the U.S. railroad system have been achieved without government subsidies or public expenditures on railroad infrastructure. The Board and Congress should be proud of these accomplishments.

The United States has the best designed freight rail system of any in the world today. Privately owned railroads compete among themselves and with other transportation providers for the vast majority of traffic, while there is substantial traffic served by only one

railroad which gives the railroads an opportunity to price differentially in their efforts to recover their full costs. The railroads own the rail infrastructure and make decisions about how the infrastructure will be used, allowing them to achieve economies of scope and density. Private capital is used to maintain and expand the railroad system without the need for any public subsidies or complex regulatory oversight. We have achieved this system in the United States precisely because the market has been allowed to guide the development of the system, with regulatory oversight limited to ensuring that any market power is not abused.

Other governments have sought to emulate the successes of the U.S. system through central planning, but, with limited exceptions, experience has shown that governmental edicts cannot replicate the benefits of market forces. Even when countries have privatized their national railways, they have generally moved from public monopolies to private ones. Experiments with open access have shown that when governments attempt artificially to create competition, the result is less competition, more bureaucracy and higher costs than the U.S. system.

Several national governments concluded in the late 1980s and early 1990s that dramatic changes were needed in the structure of their railroad systems. As described by Messrs. Rennie and Kaulbach, national subsidies for state-owned or operated railroad systems had grown to insupportable levels, infrastructure investments were not being made, and operating efficiency was declining. It was universally recognized that state-sponsored railroad monopolies could not provide the level of service required in the market. The experience of U.S. railroads since 1980 made it clear that more private ownership of railroad assets and more private, market-based decision making was the way to save failing railroad systems around the world.

Reformers looked basically to two models. Under the first approach, the government would break the national rail system into a number of separate, vertically integrated railroads, where private parties own distinct rail networks and provide operating service over those proprietary networks. The central feature of the vertically integrated model is that the owner of the roadbed also controls the investment in, maintenance of and operation over the roadbed. This, of course, is the U.S. model. See *McClellan V.S.* Under this model, competing providers of railroad service vie with one another and with their competitors (e.g., trucks and barges) to attract and retain business. The discipline of the market forces these vertically integrated railroads to provide efficient service – and to make the investments necessary to provide that service.

Under the second approach, the government would artificially create competition for railroad service by separating ownership of the roadbed from the operations over the roadbed and promoting competition among the operating entities. The roadbed costs would be covered through the exercise of market power by an infrastructure monopolist or through public subsidies. As Messrs. Rennie and Kaulbach explain, experience has shown that this open access approach is more costly, more complex and more burdensome than the system that exists in the United States. Service providers have little or no incentive to enter the market; the pricing of roadbed access raises difficult conceptual and procedural problems; and infrastructure investment lags. In the end, the open access approach does not produce the competitive benefits that it was designed to achieve. In fact, where open access has been attempted, the result has been less, not more, rail competition than in the United States.

Mexico deliberately set out to emulate the U.S. model of vertically integrated providers and it has been extraordinarily successful. Before initiating its restructuring program,

the Mexican national railroad company was losing money, suffering from unproductive assets and low productivity and losing market share to trucks. To address the deteriorating performance of its rail system, the Mexican government decided to create three vertically integrated line-haul concessions, a separate Mexico City Terminal concession, and a number of light density concessions. Reflecting the confidence investors have in the new railroad structure, the first concession, for the 4,000 km Northeast Railway, was sold for \$1.3 billion even though the Northeast Railway had lost \$700 million in 1993. The Northeast Railway concessionaires recently announced a program of substantial new infrastructure investments. Rennie/Kaulbach at 13.

The Argentine government has conducted a similar experiment. In Argentina, subsidies for the state-owned railroad in 1990 cost the government \$1.3 billion or about 1% of the Argentine GDP. Necessary investments in rail infrastructure were not being made and the railroads faced increasing competition from other transportation modes. Initially, a system of open access was considered, but it was soon clear that investors would not put substantial capital into a system when a competitor might be able to appropriate the benefits of the investment through forced access. The government eventually decided to break the existing system into 6 vertically integrated, privately-owned segments. While access to the trackage of these entities was required for passenger operations, no access was provided for competing freight providers. The reforms had immediate results. Between 1993 and 1997, railroad productivity and efficiency increased substantially and federal subsidies for freight have been eliminated. Rennie/Kaulbach V.S. at 12. According to the World Bank, the Government of Argentina is

"clearly enormously better off financially under the new system and [its] rail service has improved measurably."²¹

These positive experiences contrast sharply with the problems that have arisen in those systems that chose to adopt open access models in order to create artificial competition among the operating entities. As Messrs. Rennie and Kaulbach explain, the British experience is particularly telling. The basic scheme for restructuring the British national railway had three elements: (1) a single private owner of the roadbed – Railtrack – would be created; (2) six operating concessions would be created for freight traffic; and (3) a regulatory body would be established to oversee access to the roadbed and to ensure that access rates allowed 100% cost recovery for the roadbed owner plus a reasonable profit. Under this scheme, competition would supposedly occur among the operating entities.

In fact, virtually no competition has resulted. There was little interest by potential investors in the operating concessions. The operators would be required to pay the roadbed owner a set fee, substantially eliminating the pricing flexibility that might allow the operators to attract traffic from other modes, while at the same time the operators would be competing with other operators for a small, and possibly declining, traffic group. In the end, Wiscorsin Central acquired five of the six concessions, and the company it formed – the English, Welsh and Scottish Railway (EWS) – dominates British freight traffic on the railroad system. Ironically, by seeking artificially to create competition in the operating area, the British failed to create a system with any effective intramodal competition – it now has a roadbed monopoly and an operating monopoly.

²¹ Ron Kopicki & Louis S. Thompson, Cofinancing and Financial Advisory Services (Privatization Group), Best Methods of Railway Restructuring and Privatization, The World (Continued ...)

In addition, the British system is saddled with a host of other problems. Access agreements and regulation of access are complex; Railtrack is profitable, but it has been accused of underspending on infrastructure maintenance;²² the system is still far less productive than the U.S. system; and rail freight prices remain high – 8 cents per ton-kilometer compared to 1.75 cents per ton-kilometer in the United States. Rennie/Kaulbach at Figure 6.

Put simply, open or forced access does not work. Where open access has been attempted, it has involved a regulated roadbed monopolist – hardly the model of a competitive, market-based transportation system that shippers purport to seek here. Another lesson of open access is that it fails to promote infrastructure investment or efficient service. U.S. experience demonstrates that the development of railroad infrastructure is much more responsive to the market when use of the infrastructure is controlled by its owner. The experience of U.S. railroads also shows that the owner of costly railroad assets is in the best position to manage the use of those assets so as to achieve economies of scope and density. The efficiencies achieved by the U.S. railroads since the Staggers Act demonstrate that the current regulatory system is far superior to forced access regulation.

VI. EXISTING REMEDIES ARE SUFFICIENT TO ADDRESS THE LIMITED NUMBER OF SHIPPERS WHO ARE ACTUALLY HARMED BY THE ABSENCE OF COMPETITIVE RAIL OPTIONS

Most shippers have multiple competitive options in today's transportation market that effectively constrain or discipline rail prices. In those instances where genuine competitive

Bank, Aug. 1995.

²² See Regulation Enters A New Era, Modern Railways, Aug. 1997, at 491-94 ("Railtrack's record on investment has been unsatisfactory.")

problems exist, Congress has provided and the Board has implemented effective remedies to protect shippers from abuse of market power or anti-competitive behavior.

Remedies for unreasonably high rates are available if it can be shown that there is no effective competition to constrain rail rates – i.e., where the challenged rate exceeds the statutory jurisdictional threshold (currently 180 percent of variable costs) and where the railroad does not face effective intramodal, intermodal, geographic or product competition for the issue traffic. Upon finding a rate unreasonably high, the Board is authorized to award reparations and/or to prescribe maximum reasonable rates for the future. Consistent with the market-based differential pricing principles set forth in the Staggers Act, the Commission adopted Constrained Market Pricing (CMP) as the standard for determining the maximum rate level for market dominant traffic.²³ The CMP standard most commonly used is the “stand-alone cost” (SAC) test, which applies the principles of demand-based differential pricing to cap rail rates at the level that would be charged by a hypothetical “stand-alone railroad” providing head-to-head rail competition for the traffic at issue. Two shippers recently obtained relief under this standard²⁴ and several others have cases pending.

In enacting ICCTA, Congress responded to shipper concerns over the length and complexity of rate reasonableness proceedings. To expedite relief, Congress mandated that rate cases adjudicated under CMP standards be completed within sixteen months and the Board has

²³ Coal Rate Guidelines – Nationwide, 1 I.C.C.2d 520 (1985), aff’d, Consolidated Rail Corp. v. U.S., 812 F.2d 1444 (3d Cir. 1987).

²⁴ West Texas Utils. v. Burlington Northern R.R., Docket No. 41191 (served May 3, 1996); Arizona Public Serv. Co. v. The Atchison, Topeka & Santa Fe Ry., Docket No. 41185 (served July 29, 1997).

implemented regulations to speed up handling of these proceedings.²⁵ For "small shipper" cases, where the amount at issue does not justify the presentation of complex stand-alone cost evidence, the Board has adopted maximum rate guidelines that can be implemented more expeditiously and less expensively than CMP procedures.²⁶ In adopting the new guidelines, which rely on use of Multiple R/VC Benchmarks, the Board recognized the need to accommodate rail rate cases where SAC is too costly or traffic too infrequent or dispersed for a SAC analysis:

[A]ny simpler method will necessarily be cruder than CMP. Accuracy must be sacrificed for simplicity. This tradeoff is necessary to assure that no shipper is foreclosed from exercising its statutory right to challenge the reasonableness of rates charged on its captive traffic.²⁷

To date, only one case has been decided under this new standard²⁸ and no other shippers have availed themselves of these new remedies.

In addition to remedies for unreasonable rates, competitive access remedies are available in the event that carriers abuse their pricing and routing freedoms. Although carriers in the first instance may establish any routes, rates or service terms they find appropriate for particular movements, the Board may prescribe a through route or joint-rate to remedy or prevent

²⁵ Expedited Procedures for Processing Rail Rate Reasonableness, Exemption and Revocations Proceedings, STB Ex Parte No. 527 (served Oct. 1, 1996).

²⁶ Rate Guidelines - Non Coal Proceedings, Ex Parte No. 347 (Sub-No. 2) (served Dec. 31, 1996); see also Expedited Procedures for Processing Simplified Rail Rate Reasonableness Proceedings, STB Ex Parte No. 527 (Sub-No. 1) (served Jan. 16, 1998) ("Expedited Procedures - Simplified Rate Cases").

²⁷ Expedited Procedures - Simplified Rate Cases slip op. at 5.

²⁸ South-West RR. Car Parts Co. v. Missouri Pac. R.R., No. 40073 (served Dec. 31, 1996).

anti-competitive behavior on the part of the incumbent. Under its competitive access rules, the Board can provide relief where a carrier has abused its market power.²⁹ Upon a carrier or shipper's complaint, the Board may prevent a carrier from canceling a joint-rate or through route if the cancellation would eliminate a more efficient route. In addition to the prescription of new through routes, two other competitive access remedies are available: (1) reciprocal switching and (2) terminal trackage rights. Significantly, the rules that determine the availability of these intramodal competition remedies were adopted after the passage of the Staggers Act through a jointly negotiated effort of the Association of American Railroads and two of the nation's largest shipper groups, the National Industrial Transportation League and the Chemical Manufacturers Association.

The Board's predecessor and the courts have recognized that these competitive access standards are an integral part of the regulatory scheme established by Congress in the Staggers Act. The competitive access rules reflect the Staggers Act's strong emphasis on preserving competition and protecting shippers from market power abuses while limiting regulatory control over the railroad industry.³⁰

The Board made clear in its Bottleneck decision that shippers can obtain relief through these competitive access remedies and that the Board is receptive to competitive access

²⁹ 49 C.F.R. 1144.

³⁰ See Midtec Paper Corp. v. United States, 857 F.2d 1487, 1500 (D.C. Cir. 1988).

complaints. However, no cases have been brought alleging foreclosure of efficient routes since the Bottleneck decision.³¹

The ICC and the Board have taken other measures to simplify processes and provide additional assistance to the shipping public. At the request of the Railroad-Shipper Transportation Advisory Council (RSTAC), the Board established new voluntary arbitration procedures -- entirely separate from existing alternative dispute resolution procedures -- for resolution of disputes between shippers and carriers involving the payment of money or rates or practices related to rail transportation or service that is subject to the Board's statutory jurisdiction.³² The arbitration decisions and awards are binding and may include specific performance remedies, including short-term rate prescriptions. The new arbitration procedures provide shippers a less burdensome alternative for solving problems with railroads that will reduce litigation costs and promote private sector resolutions.

Additional vehicles exist for helping shippers resolve rail transportation problems. For example, RSTAC was created to advise the Chairman of the STB, the Secretary of Transportation and the Congressional oversight committees with respect to rail transportation policy issues of importance to small shippers and small railroads. The 15-member panel of railroad and shipper industry representatives has expressed its views and stimulated discussion on various matters, including arbitration procedures and competitive access issues.

³¹ There is currently only one case pending in which the complainant is seeking competitive access relief. Western Fuels v. The Burlington Northern and Santa Fe Ry. Finance Docket No. 41987 (filed Dec. 9, 1996) (seeking access to terminal facilities).

³² Arbitration of Certain Disputes Subject to the Statutory Jurisdiction of the Surface Transportation Board, STB Ex Parte No. 560 (served Sept. 2, 1997).

The National Grain Car Council was created by the ICC in 1995 to enhance communications between Class I railroads, short-line railroads, shippers, car manufacturers and the government as they deal with grain car supply problems. This 31-member council consisting of railroad, shipper and car supply executives is tasked with tackling the vexing problem of perennial shortage of grain cars during peak crop season.

VII. RENEWED REGULATION, IN THE FORM OF FORCED ACCESS OR OTHERWISE, WOULD CAUSE DISTORTIONS IN EFFICIENT TRANSPORTATION MARKETS AND WOULD THWART NECESSARY INVESTMENT IN THE NATION'S TRANSPORTATION INFRASTRUCTURE

A. Forced Access Would Entail Adverse Revenue Impacts for Railroads

A fundamental concern of the major railroads regarding any scheme of forced access is the impact of such a scheme on their ability to generate revenues sufficient to justify those investments in the rail infrastructure that are needed to assure adequate freight rail service over the long term. We have to assume that a principal objective of those who pursue forced access is a substantial revenue transfer from railroads to shippers which would be achieved by manufacturing more head-to-head rail competition than exists in the market today. Certainly that seems to be the purpose of those provisions of the proposed Railroad Shipper Protection Act of 1997 that would repeal the Board's 1996 Bottleneck decision.³³

A regulatory scheme that allowed shippers to direct carriers to establish junction point rates over inefficient routes so as to set up a challenge to the reasonableness of rates on relatively short bottleneck segments would have seriously adverse revenue impacts on the

³³ S. 1429, introduced on November 7, 1997 by Senators Rockefeller, Burns and Dorgan, at section 6.

railroads. Under the existing regulatory scheme, if market dominance is established the shipper can challenge the rate on the through movement and will pay no more than stand-alone cost for the through movement. Under the Rockefeller proposal, the rate will be capped at SAC on the short bottleneck segment but the rate on the longer, competitive segment will be driven down close to marginal cost. As a result of administrative adjudications and increased shipper negotiating leverage, the railroads would over time lose revenue on every movement to which the new rules would apply. The Rockefeller rules would yield no opportunities for offsetting revenue gains. They would effect a revenue transfer from railroads to bottleneck shippers, pure and simple.

In the Bottleneck proceeding, AAR submitted evidence demonstrating that the railroads would stand to lose well in excess of \$2.4 billion if the shippers' proposals now embodied in the Rockefeller bill were adopted.³⁴ Given the short timetable established for this proceeding, AAR has not had an opportunity to update these estimates. The precise magnitude of the number should not be the issue in any event. One need not quantify the dollar impact of a scheme that eliminated or substantially curtailed differential pricing in order to know that the impact would be a negative one for railroads, shippers and the nation as a whole. Revenues lost by the railroads will not be reinvested in the rail network.

While some shippers plainly seek a revenue transfer, there may be others who believe that a regime of forced access *with fully compensatory access charges* would serve the national interest better than the current regulatory scheme because it would promote increased

³⁴ Comments of the Association of American Railroads, Docket Nos. 41242, 41295 and 41626, Oct. 15, 1996, *Rockey/Klick V.S.* at 14.

competition while assuring railroad viability. Assuming that shipper interests would actually stand for the enactment of legislation that portended a possible *increase* in overall railroad revenues through fully compensatory access charges, designing a mechanism for pricing the access that users purchase would be an enormously complicated and perhaps futile endeavor, given the cost structure and traffic mix of railroads.³⁵ As Drs. Kalt and Reishus observe, regulators would inevitably "be drawn into the difficult problem of setting rates that recover the fixed and joint costs" incurred by railroads. Kalt/Reishus V.S. at 18.

To illustrate these concerns, consider the example of a regulatory scheme in which ownership of the track and roadbed is divorced from ownership of operating assets. Assume that the owner of the track and roadbed is a regulated monopolist who is entitled to fully compensatory rental payments from the competing operating railroads that use his facilities. The regulator selected to design the scheme of fully compensatory rental payments would soon find a stark reality. Not all traffic that moves on the U.S. railroad network would be able to absorb its proportionate share of fully compensatory rental that the competing operating carriers would like to impose on it. Either the traffic would leave the railroad for another mode – most likely truck – or the operating carrier would discount his prices below the level that would allow him to make the necessary rental payment to the landlord track owner. At some point in the process, the regulator would presumably try to design a scheme of demand-based rental charges that allowed the price sensitive traffic to remain on the railroad and make some contribution to the landlord's fixed costs while traffic with inelastic demand would bear a higher share of the

³⁵ The Federal Communications Commission and state regulators have struggled mightily with the design of charges for access to the local telephone network since the enactment of the Telecommunications Act of 1996 and have not yet succeeded. Kalt/Reishus V.S. at 19.

rental payments. Assuming this regime of demand-based rental fees could be imposed, there would be little change from the existing scheme – and little if any benefit from price competition. But unless the competing operating carriers were required by the regulator to impose the appropriate demand-sensitive rental charge on all customers, the competing operating carriers would have the incentive to discount their rates downward toward the level of their marginal operating costs, in which case the objective of fully compensatory access charges would be defeated.

In addition to ending unhappily, the foregoing hypothetical involves an heroic assumption regarding the regulator's ability to determine demand-based rental charges for different movements of traffic. In reality, this could probably not be achieved because regulators are not equipped to calculate elasticities of demand in dynamic markets.³⁶ The costs of increased regulatory involvement and the inefficiencies stemming from charges determined through regulation rather than through marketplace decisions makes a scheme of this sort profoundly unattractive.

B. Forced Access Would Result in an Inefficient, Less Productive Rail System

Apart from the seriously adverse impacts on railroad revenues and investment, any regime of forced access would result in inefficiencies that would be harmful and disruptive for railroads and their customers. AAR previously addressed in its comments in the Bottleneck case the operating inefficiencies attendant upon a scheme of shipper-initiated junction point routing and will not repeat those comments here. The inefficiencies that we discuss here are

³⁶ Coal Rate Guidelines, 1 I.C.C.2d at 527.

those that would arise either from (1) divorcing ownership of roadbed and track from ownership of operating assets, or from (2) mandating operations by competitors over one another's tracks. In either circumstance, forced access is likely to result in increased costs by dissipating economies of density and to disrupt functions that are today carefully coordinated under railroad management that has the incentive to optimize the performance of the enterprise as a whole.

Drs. Kalt and Reishus explain that the economies of density that railroads have achieved in the post-Staggers era could be jeopardized under a regime of forced access:

[T]o the extent that use of access by a shipper reduces the traffic density for the incumbent railroad, operating costs are likely to increase. With the economies of density in rail operations, two carriers that split the traffic on a line are likely to require more total resources in terms of crews, locomotive power and cars in order to maintain the same total quality of service than would a single operating railroad.

Kalt/Reishus V.S. at 20. Where a line is shared by two carriers under a scheme of open access, another potential undesirable effect is that the reduced volume of traffic either of them would likely handle would result in less frequent train service.

Forced access would necessarily entail some "unbundling" of functions currently performed by vertically integrated railroads. This unbundling would likely give rise to very serious coordination issues and would almost certainly result in less efficient decisions than those made today in the United States rail industry.

As Drs. Kalt and Reishus point out, cars of freight moving over a railroad are not fungible like electrons moving over the transmission grid or natural gas flowing through a pipeline. The same segment of rail line may be used to handle time-sensitive intermodal traffic, unit trains hauling coal or grain, automobiles and many different types of general merchandise

traffic. The value of the different commodities handled, their time sensitivity, and the prices at which they move can vary greatly from one car or train of freight to another. The non-fungible nature of rail traffic has significant implications for purposes of marketing, operating and investment decisions. Given the constraints of scarce capacity and scarce capital, railroad management is continuously being called upon to answer the following sorts of questions:

- What segments of traffic to pursue most vigorously in the effort to obtain the optimal mix of traffic in light of the railroad's physical configuration and revenue needs;
- How best to allocate productive resources (e.g. locomotives and train crews) among various commodity groups;
- How to route traffic over the rail network so as to meet the scheduling demands of various categories of traffic and avoid congestion;
- How to allocate capital dollars among various competing projects that will have different yields for differing segments of the business.

Each type of question raises difficulties in its own right. Coordinating the answers to all these questions simultaneously is enormously difficult – it is the challenge that railroad management faces. See McClellan V.S. at 3-5. Management's incentive under the existing scheme is clear – the goal is to achieve optimal results for the enterprise as a whole.

Whatever form it might take, forced access to the railroad network would result in parties with different incentives – sometimes very different incentives – being forced to coordinate answers to questions of the sort sketched out above. Take a simple example. Suppose that railroad A and railroad B both operate over railroad B's lines, with A doing so under a requirement of forced access. Railroad A specializes in high speed intermodal trains moving in regularly scheduled service. Railroad B handles large volumes of general

CERTIFICATE OF SERVICE

I hereby certify that a true and correct copy of the foregoing document was served on all Parties of Record by first class mail or more expedited means of service on this 26th day of March, 1998.

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devoted to solving today's service problems and investing in a safer and more efficient rail system for the future.

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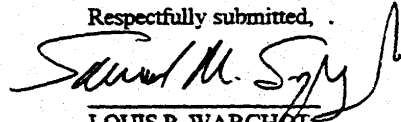
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merchandise traffic that requires extensive classification. Capital (from all sources including access fees) is scarce. Railroad A wants to use the available capital to clear a tunnel on the line so that it will accommodate doublestack trains. Railroad B wants to use the same capital to build a new yard so that it can classify its merchandise traffic more efficiently. There are not enough dollars to do both projects. Who decides how the capital is spent? Equally important, where is the incentive to make the decision that yields the best results for society as a whole? If there were no Railroad A in the picture and railroad B handled both types of traffic, there is reason to believe that railroad B, if competently managed, would reach the decision that resulted in the best use of the available assets.

These are precisely the sorts of coordinating decisions that are made day after day by existing railroad managements as they strive to design increasingly efficient railroad network. Under a regime of forced access, the need for such multiple decisions would either have to be reached through a tug of war between parties with conflicting priorities or through the intervention of a regulator. In either case, the consequences would be lost efficiencies and increased costs.

CONCLUSION

For the reasons set forth in these Comments, AAR urges the Board to report to Congress that there is no need to overhaul the statutory scheme providing for the economic regulation of the railroad industry. The Board has sufficient tools and discretion under the existing scheme to deal with any abuses of market power. Additional regulation would drain the resources of both railroads and shippers at a time when those energies and resources should be

SURFACE TRANSPORTATION BOARD

STB Ex Parte No. 575

REVIEW OF RAIL ACCESS AND COMPETITION ISSUES

STATEMENT OF

ROBERT D. KREBS

APRIL 2, 1998

My name is Robert D. Krebs. I am the Chairman, President and Chief Executive Officer of The Burlington Northern and Santa Fe Railway Company ("BNSF"), 2650 Lou Menk Drive, Fort Worth, Texas. I became Chief Executive Officer of BNSF in September 1995, when BNSF was created pursuant to the Interstate Commerce Commission's authorization of the common control of Burlington Northern Inc. and Santa Fe Pacific Corporation and their wholly-owned railroad subsidiaries.

I am submitting this statement in response to the Surface Transportation Board's request in Ex Parte No. 575 for comments concerning access and competition issues in the rail industry so that it may respond to inquiries from Congress on such issues as a part of its legislative oversight. The decisions that are made in dealing with these issues will determine whether the American rail industry will be able to maintain and expand upon its remarkable revitalization and the intensified competition triggered by the passage of the Staggers Act in 1980.

Introduction

The rail industry was on the brink of collapse in the 1970's because of unreliable service, non-competitive rates, and a deteriorated physical plant with massive deferred maintenance. The Staggers Act has changed that picture dramatically, and the industry in general and BNSF in particular have responded to the commercial opportunities presented by the Staggers Act and have produced tangible benefits for customers -- lower rates, a more efficient rail network, expanded market coverage, decreased loss and damage claims, and vigorous competition. In addition, safety on the railroads has improved significantly since the Staggers Act due to the ability of the railroads to make the investments in the training, equipment and infrastructure necessary to reduce personal injuries and to help avoid derailments and collisions.

The service problems the industry has faced since mid-1997 in the West are serious and have shaken the confidence of rail customers that the railroads can meet their needs for efficient and reliable service. As it has shown, the STB has the power under the present regulatory structure to play an active role in addressing these problems by working with carriers and shippers, and BNSF is committed to listening to its shippers and to working with them to meet their needs and to improve service, reliability and consistency.

However, as shippers, industry representatives and the STB have recently observed, the industry's current service problems are not caused by lack of competitive access as some have argued. Rather, the problems are caused by insufficient rail capacity that can only be remedied by continued substantial investment in infrastructure.

The issue before the Board, therefore, should be how best to position the rail industry to be able to continue making the on-going infrastructure investments required to meet the growing transportation needs of shippers and the public.

The Historic Context

When I joined Southern Pacific in 1966, the prospects for the industry were dim due largely to the heavy burdens of regulation. The infrastructure of the rail industry in the 1960's and 1970's was starved for the investment necessary to maintain and increase capacity. Shippers could not rely on rail carriers as near term or long term service providers, and safety was not a focus of the industry. Railroads had been losing market share to trucks for years because rail rates were not competitive and service was poor. Track and equipment maintenance was slipping. Reinvestment in the nation's rail infrastructure was negligible. Transit times were often measured in weeks, and only rudimentary data systems were available to provide shippers with data about their shipments.

The cycle of declining revenues, under-investment, insufficient maintenance and poor service drove many railroads out of business. Nearly one-third of the Class I railroads that existed in 1976 were earning negative returns on investment, and at least ten railroads went into bankruptcy during my first 15 years in the business, including such well known names as the Penn Central, the Rock Island and the Milwaukee Road.

Deregulation and The Staggers Act

The Staggers Act has been a resounding success. It established an economic and legal framework which provided the railroads the first opportunity to show their competitive mettle in a largely deregulated environment and to provide customers with more reliable and consistent service. Deregulation gave us the incentive to invest, cut costs and achieve efficiencies that enabled railroads to compete vigorously in the marketplace. Shippers and railroads were at last able to negotiate rates, terms, and conditions that best suited them and their business needs. Customers benefited as we provided steadily better competitive service at lower rates to more customers.

The investments made possible by the Staggers Act have paid off for all of our customers. Indeed, there have been remarkable volume and efficiency gains in the rail industry since 1980. For instance, between 1980 and 1996, among Class I railroads:

- Total revenue ton-miles increased from 919 billion to 1,356 billion;
- Intermodal traffic (including some non-Class I carrier traffic) increased from 3.1 million trailers and containers in 1980 to approximately 8.1 million trailers and containers in 1996;
- Employee productivity increased more than threefold, with revenue ton-miles per employee growing to 7.5 million per year from 2.1 million;
- The number of net ton-miles per train-hour increased more than 50% from 40,392 to 64,015;
- Asset productivity improved substantially, as freight car and locomotive fleets were reduced by 27% and 31%, respectively; and
- Fuel efficiency increased to 379 revenue ton-miles per gallon from 235.

The Staggers Act has led to similar success at BNSF. For example, in 1978, traffic over BNSF's predecessor railroads generated just under 199,000 million revenue ton-miles. By 1997, that figure had grown to approximately 429,000 million revenue ton-miles, an increase of over 115%. In addition, efficiency has improved significantly on BNSF since the Staggers Act. For instance, fuel efficiency on BNSF increased to 385 revenue ton-miles per gallon in 1996 from 247 revenue ton-miles in 1980. This growth in traffic and improved efficiency have been accompanied by significant improvements in service and safety and by substantial reductions in rates.

For instance, our capacity to handle increased shipper demand has grown through massive investment in yards, intermodal facilities and equipment. In the three year period from 1996-1998, we estimate capital spending by BNSF will reach just under \$7 billion. About \$3.5 billion of that amount is for maintenance of our infrastructure – 9.7 million ties, 3,188 miles of new rail, and over 35,000 miles of track resurfacing.

The balance of these expenditures is predominantly for expansion. Major projects include the reopening of the 229-mile Stampede Pass line in western Washington to increase our capacity to handle intermodal, grain and general merchandise trains to and from the midwest, investments in grain gathering lines to reach outlying farms and elevators across the northern United States, rehabilitation of the 194-mile former SP Iowa Junction-Avondale line and Lafayette Yard in southern Louisiana, and double tracking of over 450 miles of line on some of our most important routes. We are also expending large sums to expand our intermodal and carload yard facilities, including the Argentine Yard in Kansas City and the Hobart Yard near Los Angeles, where we

anticipate that our capacity to handle port-related traffic will grow to one million lifts per year. In addition, all BNSF shippers, most notably unit train customers such as coal and grain shippers, have benefited from huge investments in BNSF's state-of-the-art Network Operations Center in Fort Worth, TX. That facility's sole purpose is to enhance the on-time performance and safety of train movements on BNSF's 34,000-mile network.

BNSF has also made significant investments in locomotive and freight cars since 1996 to improve its competitive service to customers. In 1997 alone, BNSF spent over \$800 million on capital equipment expenditures. In addition, BNSF will have taken delivery of 867 new locomotives in 1996-98, increasing our road fleet by 25%. BNSF has invested over \$150 million over the past 22 months in its information systems to provide better control over assets, improve information flow between BNSF and our customers, and improve overall service reliability.

The improved transit times and reliability made possible by these investments will permit BNSF to better serve its shippers and become an integral part of their supply and distribution chains. With more accurate and timely information on its shippers' needs and how its service is meeting those needs, BNSF is better able to identify areas where service improvements are necessary, and BNSF is continually working with shippers to find solutions to today's challenges. For example, in the forty-five day 1997 peak UPS service season -- the largest peak season ever handled by a railroad for UPS, BNSF handled over 43,000 trailers without a service failure. Similarly, we are currently operating at close to 100% on-time for our coal and grain shippers, and our on-time

system-wide performance for the first quarter of 1998 is exceeding 85%. We plan to continue improving that performance in the future.

Safety on BNSF has also improved significantly since the Staggers Act due to the ability of the BNSF to make the necessary capital and other investments to assure safe operations. For example, from 1995 to 1997, BNSF spent approximately \$17 million on its Positive Train Separation program and expects to spend an additional \$6 million on that program in 1998. Similarly, in order to reduce the risk of grade crossing accidents, BNSF is spending \$10-12 million per year on grade separations, upgrading signals at crossings and road crossing surfacing. BNSF is also leading the industry in the use of electronic brakes. We will spend more than \$5 million from 1996 through 1998 to equip locomotives and freight cars with such brakes. Ten trainsets are already so equipped on BNSF (seven BNSF sets and three shipper-owned sets), and several additional equipped trainsets are anticipated to enter service in 1998. Further, between 1995 and 1997, reportable employee injuries per 200,000 hours worked declined by almost 40%, and lost days per 200,000 hours worked declined by more than 50%. BNSF's 1998 goal is to reduce its employee injury rate an additional 25% below 1997's already reduced level. However, the development and deployment of these new technologies and the improvements in safety and efficiency they can bring will require ongoing substantial capital investment in the years ahead.

BNSF's growth in traffic has been accompanied by significant reductions in rates to meet customer expectations, changing markets, and intense competition. Between 1981 and 1997, the average system-wide revenue per ton-mile on BNSF decreased by

just over 50% in inflation-adjusted dollars, from \$2.42 to \$1.20. These rate reductions have been realized for all of BNSF's traffic commodities.

For instance, the average freight revenue per ton-mile in inflation-adjusted dollars for all agricultural commodities has decreased by 56% since the Staggers Act took effect. As one example, from 1981 to 1997, the rate charged by BN (now BNSF) for 52-car Pacific Northwest ("PNW") export wheat from Montana decreased by 32% in constant 1981 dollars. A Montana grain shipper in 1981 paid BN \$0.71 per bushel of wheat shipped via a 52-car unit train to the PNW for export. That 1981 rate adjusted for inflation would be \$1.26 per bushel in 1998. However, the 1998 actual rate charged by BNSF for such transportation is only \$0.86 -- 32% below the inflation-adjusted rate.

Other examples of BNSF rate reductions include coal transportation. The average revenue per ton-mile for coal declined 45% in inflation-adjusted dollars between 1981 and 1997. These rate declines have not been limited to coal shippers that have competitive options for service out of the Powder River Basin. All coal shippers are paying lower rates because of the productivity gains BNSF has achieved through massive investments in new capacity and new technologies.

Virtually every shipper has benefited from post-Staggers rail rate reductions, whether or not it is served exclusively by one rail carrier. As the Board itself has recognized in a recently released report, rail rates have declined over 46% in constant dollars since 1981. But not every shipper can or should pay the same rates. The demand-based rate structure under Staggers leads to different rates for shippers in different circumstances, but ultimately results in lower rates for all shippers than

otherwise would be possible. Some shippers pay more than the overall average cost of transportation while others pay less than the average cost. However, because all shippers contribute to covering the huge fixed costs of railroad plant, they all enjoy rates and services that would not be available if all rates had to reflect average cost. This system of rates can work if, and only if, carriers are permitted to differentiate rates according to market demand.

The growth in revenues from all of our commodity groups, including such bulk commodities as coal and grain, and other traffic such as chemicals and general merchandise, has made possible the continuing investments necessary to provide reliable and efficient service and to compete effectively not only with other railroads, but also with trucks and other transportation modes. Our ability to operate more efficiently has enabled us to both price our services competitively and make progress toward covering all of our fixed costs.

We already have a strong incentive to keep rates to all shippers as low as possible. BNSF is in a partnership with its shippers to move as much traffic as possible. Whether or not a shipper is served exclusively by BNSF, we have no incentive to price our service at rates that discourage use of our railroad or that make the shipper uncompetitive in its markets. However, we cannot justify the necessary capital investments, and indeed our Board of Directors would not approve such investments, unless we are confident that we will earn an adequate return on the capital employed in the business. And, for all my optimism about the future, it remains true that such adequate returns have not yet been realized on an overall basis, either for BNSF or for

the industry as a whole. Inadequate returns not only deter investment, they also make it more expensive to obtain funds from the capital markets. Declining revenues and reduced capital expenditures would harm railroads in the near term, and shippers would also suffer in the long term from a railroad infrastructure that would not be able to keep pace with their needs.

**The Ongoing Need for Capital Investment
to Remedy the Current Lack of Capacity**

There are serious service problems in the industry, particularly in the West. However, as the Congressionally-established Railroad Shipper Transportation Advisory Council has recently concluded, the current industry problems are due to insufficient capacity, not the lack of competitive access. Continued improvements in the industry infrastructure and service can only be achieved through continued capital investment, and investment can be attracted only by maintaining the current demand-based pricing structure. If railroads are not given the opportunity to recover, and achieve a fair return on, their investment costs, they will not attract the capital necessary to invest in track construction and maintenance, to upgrade yards, and to undertake other infrastructure and service improvements required to keep them competitive. The service and safety improvements which have been achieved also cannot be maintained and expanded without continued massive capital investments. While rail continues to be the cheapest and safest form of transportation for most goods, it has achieved that because of our ability to invest. Anything that interferes with the ability to attract capital would lessen our ability to be the lowest cost and safest provider of land transportation services.

Indeed, the STB has expressed its concern in the Service Order No. 1518 proceeding that the infrastructure throughout the West may not be able to handle increasing traffic volumes. For instance, the Board has concluded that significant capital investment will be needed to improve the Houston terminal infrastructure.

The problem of insufficient capacity cannot, however, be remedied by forced rail access. Indeed, forced rail access would only exacerbate the capacity problems and would require massive reregulation of the rail industry. As recently observed by Secretary Slater, forced access to other carriers "could be operationally chaotic and could undermine the economic viability of the rail system."¹⁷ Further, although implementation of the Staggers Act has reversed the long-term decline of the rail industry, the recovery is not complete. While returns on investment have shown improvement since 1980, the average return on investment, even in peak years, is well below the cost of capital as determined by the ICC/STB, and the average return on equity for Class I railroads averaged almost 10% below the average for the S&P industrial index between 1988 and 1995.

The service problems caused by insufficient investment and undercapacity can only be remedied by adhering to policies that are sensitive to the needs and requirements of the investment community. Investors expect reasonable earnings and reasonable growth, and the regulatory environment must be stable and consistent.

Forced rail access would, however, undermine investor confidence and reverse the post-Staggers trend of improved earnings, enhanced financial stability and increased

¹⁷ "Slater: In His Own Words", 252 Traffic World, No. 5 at 17 (Nov. 3, 1997).

investment. Forced rail access would also increase regulatory uncertainty and market risk; it would undercut growth expectations and very likely reduce expected rail earnings. Each of these would in turn chill the enthusiasm of investors and drive their capital to other uses.

Moreover, forced rail access would reverse many of the network and system efficiencies brought about by the Staggers Act. The pre-Staggers regulatory scheme effectively compelled the railroads to operate numerous inefficient routes. They were unable to concentrate traffic on the most efficient routes and gateways, and their ability to compete was diminished. Staggers reversed that system and allowed the railroads to invest in a streamlined and much more efficient and competitive network. Forced rail access would result in the breaking up of a nationwide network of single-line and run-through train service and efficient blocking in favor of a splintered, slower and less competitive service with inefficient car utilization and supply.

In addition, under a system of forced rail access, the Board would have to reinject itself into the ratemaking process, establish the priorities for and the terms and conditions for allocating rights to use tracks, and, in short, reverse the deregulatory direction of the Staggers Act and the progress made thereunder.

It is evident that forced rail access is shorthand for a return to regulatory models that failed in the past. Forced open access would both exacerbate the problems caused by the current insufficient capacity and undercut the success achieved by regional and shortline carriers in keeping branch lines operative and in preserving rail service to

shippers on those lines. This is not the time to undo almost twenty years of steady progress.

The Rail Industry Is Competitive

The industry's post-Staggers capacity expansion and safety achievements have been attained while the industry has become competitive as to price and service. Competitive discipline, demonstrated by declines in real rates, is provided not only by other rail carriers, but also by motor, barge and pipeline carriers. Product and geographic competition restrain many other markets. For instance, in the critical grain and coal markets, there is substantial downstream source competition that restrains the rates we can charge. Export grain markets, for example, are extremely competitive and if we try to impose inappropriate rate increases we will simply price ourselves out of the market. Thus, if one of our export grain shipper's prices are too high because our transportation rates are too high, then that shipper will be unable to participate in the export market, and both the shipper and BNSF would lose that business opportunity.

Similarly, because electric utilities have multiple alternatives for acquiring the coal they need, the prices we can charge for transportation of coal to a particular location without losing the business altogether are strictly limited. That is all the more true since the advent of utility deregulation, which is forcing utilities to pursue such alternatives even more aggressively. In addition, the recent merger activity among electric utilities has created massive firms with negotiating leverage which can more than hold their own in negotiations involving rates to exclusively served plants. Further, the ICC/STB has acted to preserve existing competition in each of the rail merger and control transactions

submitted for review. It has imposed significant pro-competitive conditions (often in favor of electric utilities) on many of those transactions, and denied the proposed ATSF/SP transaction outright.

The Role of the STB

Congress and the ICC/STB recognized that the shift to a demand-based pricing system required the adoption of measures designed to protect shippers when competition is found to be inadequate or there is a risk that market power will be abused. For instance, the STB's competitive access regulations enable a shipper to secure access to a second carrier if it is shown that the existing carrier has abused its market power through its rates or service. Further, the STB rules provide a mechanism for determining maximum reasonable rates where a rail carrier is "market dominant". In addition, Congress mandated and the STB has implemented streamlined and simplified procedures for rate challenges by small shippers, i.e., non-coal rate guidelines.

These rate protections do work, and the ICC/STB has taken a balanced, even-handed approach to dealing with rate reasonableness challenges. For instance, while BNSF prevailed in the McCarty Farms proceeding, we were ordered to provide rate relief and to pay \$40 million in reparations in the Arizona Public Service and West Texas Utilities proceedings.

As to service protections, the emergency service order provisions in the ICCTA enable the STB to act when shippers do not receive adequate service. Moreover, there are avenues for recovery of damages caused by inadequate service for both contract and common carrier traffic.

While BNSF believes that it is of critical importance to maintain a demand-based pricing structure and that the existing statutory and regulatory protections provide shippers with adequate protection, we recognize that some have expressed concerns about the effectiveness of existing statutory and regulatory opportunities to seek relief from rate and service problems. In particular, shippers have claimed that they cannot obtain relief in a timely manner and that the procedures for obtaining relief are too difficult and cumbersome. In order to address those concerns, the STB may want to consider establishing an advisory committee to undertake a negotiated rulemaking to identify and address specific shipper concerns about cumbersome procedures. Such an approach would enable the STB to consider proposals for action that have been developed by the parties in a negotiated, consultative context rather than in a potentially adversarial, traditional regulatory proceeding. Among the possible areas for Board consideration are:

- The STB could require railroads and shipper organizations to meet periodically to forecast and plan, for example, for peak agricultural demand periods so that the railroads can better serve shipper needs.
- The STB could require railroads to report periodically on their responsiveness to shippers' concerns and needs.
- The STB could require railroads to provide improved advance notification of major and long-term service changes so that shippers could plan their shipping and delivery cycles in order to better accommodate those changes.
- The STB could reduce the required showing for relief for service-related problems under the competitive access rules or the emergency service order rules.

In addition, we support the use by the STB of more expeditious procedures for handling all rate reasonable proceedings and the elimination of as many regulatory and administrative hindrances to the prompt and efficient resolution of such challenges as possible at reasonable cost to small shippers.

Conclusion

In conclusion, I believe that the current demand-based or differential pricing system is functioning well and as anticipated by Congress when it adopted the Staggers Act. Any fundamental changes in the existing structure would necessarily imperil the service and safety achievements that have been reached, would restrict the rail industry's ability to compete with other modes of transportation, and would inhibit the capital investment that is required to maintain and increase the capacity of the domestic rail system so that the United States can maintain its ability to compete in the expanding global economy. Broad-based open access would both exacerbate the problems caused by the current insufficient capacity and undercut the success achieved by regional and shortline carriers in keeping branch lines operative and in preserving rail service to shippers on those lines. A return to a pre-Staggers Act style of regulation would bring with it all of the pitfalls and weaknesses Congress sought to remedy with that Act and would undercut the revitalization of the industry in the post-Act era.

BNSF would, however, be willing to join with the Board and the shipping community in addressing the concerns that have been raised. We believe that, by considering proposals such as those I have mentioned above, the existing incentives for rail infrastructure investment and competitiveness of the industry can be maintained

while the concerns of the shippers with respect to service, procedural delays and other issues can be addressed and appropriate resolutions reached.

Thank you for your time, and I would be pleased to answer any questions you may have.

SNOW

TESTIMONY OF JOHN W. SNOW, CHAIRMAN,
PRESIDENT AND CHIEF EXECUTIVE OFFICER,
CSX CORPORATION
BEFORE THE SURFACE TRANSPORTATION BOARD
APRIL 2, 1998

Madam Chairman, Vice Chairman Owen, I am John W. Snow, the Chairman, President and Chief Executive Officer of CSX Corporation. I appreciate the opportunity to appear before you today to discuss the current state of the rail industry. Having spent a good portion of my professional life around railroads in a public policy position at the Department of Transportation and working in the private sector for CSX and its predecessor companies, it gives me great pleasure to report today that the fundamentals of the rail industry are strong, moving in the right direction, and benefiting the economy and the public. At CSX, rail revenues are up, and so too are investments in safety, technology, and upgraded track and equipment. More freight is moving on railcars than ever before, and that freight is moving safely and efficiently.

Should anyone conclude from this assessment that everything is perfect in this industry? Of course not! We are all painfully aware of the service difficulties that have occurred recently in the western United States. I don't purport to know the specifics of the Western railroad situation and, therefore, am not in a position to offer specific insights into it. Clearly, the

current rail capacity in the Houston corridor is being strained at least in part from the rapid and unforeseen growth in traffic, particularly chemicals. The appropriate response appears to be deploying new infrastructure, as the Union Pacific has proposed. These are serious problems, but I am confident they will be fixed. However, it is important to note that they are an aberration, and provide no basis for changing the regulatory system. We have to be very wary of changes that are portrayed as "minor" but are significant, and changes that don't "fix" the problem but rather make it much worse. Just the specter of reregulation could chill the capital markets' willingness to provide the capital necessary to strengthen the Union Pacific and the entire industry. I reiterate that the fundamentals of the industry are sound, and note that the benefits have occurred at a time when rail rates are roughly one-half of what they were twenty years ago.

It wasn't always so. In the 1960s, our Nation's railroads were in a precarious condition. In 1970, the Penn Central Railroad went bankrupt, followed in quick order by six Class I railroads that had provided service throughout the Northeast. Remaining railroads were unable to generate sufficient revenues to reinvest in their existing infrastructure, much less invest in new capital improvements required for efficient rail service. Great segments of the railroad system were barely functioning. Trains operated at reduced speeds on one out of every seven miles of track in the Nation;

in some places, trains operated on mainline track at only 10 miles per hour. Derailments numbered in the thousands annually, because of deteriorated roadbeds. In fact, some track was so bad that "standing derailments" occurred when trains were not even rolling! Shippers couldn't move their commodities by rail, manufacturers suffered from lack of supply, and consumers paid high prices for the system's inefficiencies. More and more customers were turning their backs on railroads, and were forced increasingly to ship their goods by truck. The situation was so bad that some believed that the rail freight system needed to be nationalized. "Rail service" was truly an oxymoron. We were at the brink.

It is important to remember that these conditions developed and worsened when governmental regulation ruled our industry. The basic federal policy toward the railroads had remained virtually unchanged for almost a century after this Board's predecessor, the Interstate Commerce Commission (ICC), was created in 1887. Originally established to protect shippers from the threats of monopolistic behavior by carriers, the ICC's regulatory authority was augmented throughout the years. But the foundation of its activities -- nearly complete governmental control -- remained constant. The rail industry was ruled externally by regulators and internally by lawyers. In the 1960s, more than 600 hearing examiners sat in Washington determining prices of goods moving on virtually every mile

of railroad track. Railroad routes that were obviously uneconomic could not be abandoned until after a lengthy regulatory review. The impact on the industry was devastating. It was, Madam Chairman, as you correctly described, the epitome of regulation, and was "associated with large, cumbersome, over-reaching bureaucracy".¹ These were not the "good old days".

The situation for railroads had reached crisis proportions. In 1973, Congress adopted legislation providing for the formation of Conrail from the remains of the bankrupt Northeast railroads. I served as Deputy Undersecretary at the Department of Transportation under Secretary Bill Coleman on his senior policy team. As the deterioration in the industry continued, in a bipartisan fashion the Ford Administration and various members of Congress proposed reforms in the rail regulatory arena. Transportation leaders in both the public and private sectors eventually concluded, as Secretary Coleman indicated, "[I]f there is to be a revitalized freight rail system in this country, there must be fundamental reform of the

¹ Christopher Dinsmore, *Little-Known Board Has A Lot Of Clout; When Agency's Chairman Spoke, Norfolk Southern, CSX and Conrail Listened*, The Virginian-Pilot, January 26, 1997, at D1.

economic regulation of the railroads.²¹ I described the railroads'

predicament as follows:

In short, the railroads are in a vicious cycle. Low earnings rob them of the ability to make improvements in plant which are needed to reduce costs and improve service. The inability to reduce costs and improve service hampers the competitive position of railroads and adversely affects their net income -- so the cycle is repeated. If we are to revitalize the railroad industry and achieve the full measure of benefits which healthy, progressive railroads can offer, it is essential to break this cycle.²²

Incremental change built on the tentative steps begun in 1973. The Railroad Revitalization and Regulatory Reform Act (the "4-R Act") was enacted in 1976. The 4-R Act set forth a national goal that rail carriers should be able to earn "adequate revenues" as private sector companies by permitting them to raise or lower rates in response to market forces. In addition, the 4-R Act allowed the abandonment of rail lines that were

²¹ *Railroads-1975: Hearings on Legislation Relating to Rail Passenger Service Before the Subcomm. on Surface Transportation of the Senate Comm. on Commerce, 94th Cong. 94-31, Part 5 (1975) (statement of Secretary Bill Coleman, United States Department of Transportation).*

²² John W. Snow, *The Ford Administration's Proposal For Rail Regulatory Reform, in Railroad Revitalization and Regulatory Reform, 71-72* (Paul W. MacAvoy and John W. Snow eds., 1977)

unprofitable, and other vestiges of ICC regulation over day-to-day aspects of managing the rail system were eliminated. But the needed reforms were not yet complete.

In 1980, through the Staggers Rail Act, the Congress substantially altered the government's approach to the industry. Senator Howard Cannon (then-Chairman of the Senate Commerce, Science, and Transportation Committee) noted when he introduced this legislation that, "most observers agree that economic regulation has exacerbated the railroads' problems."¹ / The Staggers Act lifted much of this regulation, and provided the rail industry with many of the same market freedoms available to other competitive industries. It was intended, as President Carter said in signing the bill, to "create an environment in which the railroads themselves can regain their economic health by aggressively improving their operations and profitability."² / Antitrust immunity over collective ratemaking was removed, rail rate regulations were reduced, and merger impediments were eased. Market forces, not the government, became the principal economic regulator of rail service. The Congress recognized the terrible distortions caused by almost 100 years of overreaching regulation and

¹ 125 Cong. Rec. S15309 (October 29, 1979) (statement of Sen. Cannon)
² President's Message to Congress Transmitting Draft of Proposed Legislation to Reform the Economic Regulation of Railroads, And for Other Purposes, 15 Weekly Comp. Pres. Doc. 459 (March 26, 1979).

dramatically chose a different course. The Act permitted selective deregulation of rates for commodities over which the railroads lacked market dominance. Rates were to be negotiated, rather than set by government employees. Today, the lion's share of rail traffic moves under rates established in a free market setting, with only a small percentage subject to Board jurisdiction, in those instances where the railroad is market dominant.

The Staggers Act also freed the railroads to phase out rail lines that were duplicative or on which revenue was being lost. Since 1980, Class I railroads have reduced significantly the miles of track they own, from 271,000 in 1980 to 106,000 in 1996. Improved earnings, the possibility of achieving adequate revenues, and a stable regulatory environment have given CSX and other railroads the essential ability and the incentive to attract the capital funds we need to invest in our infrastructure.

Although decried by some rail critics, I submit that the rail consolidations since 1980 have led to both better service and lower prices for the shipping public. Better service exists because inefficient routings have been eliminated, transit times have been reduced through increased single line service, and improved car utilization was the result. Better prices ensue from the ability of rail carriers to lower their costs by

eliminating expensive interchanges and achieving better equipment utilization, which in turn allows carriers to reduce rates for their customers.

Since the enactment of the Staggers Act, we have seen an explosion of improved rail performance. The ton-miles of freight shipped by rail has increased 49 percent since 1980. Average rail rates, adjusted for inflation, have fallen more than 50 percent. Train accidents and derailments have declined by almost 70 percent, while fuel efficiency has risen by more than 60 percent. In this decade, railroads invested more than \$100 billion to maintain and improve tracks and equipment. Industry-wide, delivery time for rail shipments has improved by nearly 30 percent, resulting in billions of dollars of benefits for shippers.

Since 1981, CSX has invested \$14 billion in track and structures and \$1.2 billion in new locomotives. For 1998, our capital budget is \$806 million, not including sizable investments we are making to prepare for the Conrail acquisition, if it is approved. For example, we are spending over \$245 million to improve and expand capacity on approximately 270 miles of the former B&O route between Ohio and Chicago. The section of railroad being upgraded and expanded will link Cleveland and the eastern markets of Boston, New York and Philadelphia with the industrial heartland of America and the gateway in Chicago to and from the West.

As we move forward in our industry, safety of course continues to be our highest priority. I am pleased to report that since 1980 CSX has achieved an almost 80 percent reduction in accidents per million train miles, and an almost identical reduction in personal injuries per 200,000 personnel-hours since 1982. Overall, the industry's safety performance has been steadily improving. According to the Federal Railroad Administration's statistics, the number of rail accidents per million train miles has trended downward, and was 68 percent lower in 1996 than in 1980, when the Staggers Act was enacted. The number of injuries and illnesses per 200,000 personnel-hours has decreased as well, and was 67 percent lower in 1996 than in 1980. These and other data absolutely disprove any notion that deregulation leads to decreased safety in the rail industry.

In reviewing these accomplishments, it is hard to believe that we are witnessing the same industry that teetered on the brink of total collapse just 25 years ago. Deregulation has been an unqualified success. As a result of deregulation, we have lower rates, but financially stronger carriers. We have more capital available for the industry. And we have a safer industry.

What accounts for this turnaround? The answer is obvious: competition brought about by deregulation. The market, not the government, is now the driving force in the railroad industry, just as it is for

our intermodal competitors, trucks and barges. The "ever-expanding web of outmoded and often irrational economic regulation" to which Secretary Coleman referred has been replaced by marketplace forces. In the railroad world today, intramodal, intermodal, product and geographic competition constrain prices, not the government. Consumers have access to more products at fairer prices than before. The benefits of deregulation -- whether in service, track condition, price, labor relations, or customer satisfaction -- are numerous.

In spite of this documented success, there are those who would have us return to yesteryear. Some shippers want to wrest power from the marketplace and return it to the government. "Competitive access" and "open competition" are their slogans. These are really codewords for "forced access", in which the government sets rates for rail freight service, and requires a railroad to permit its competitors to operate over its tracks -- privately owned tracks, I would note, in which the owners have legitimate property interests. Despite the denials that this is just "tinkering" and not an attempt to reregulate, make no mistake about it -- this effort is a direct assault on deregulation.

"Competitive access" means that the government dictates how the railroads carry out their business. Control of the day-to-day operation of the freight railroads would be stripped from the private sector, including the

setting of rates, operating conditions, yard usage, and other elements necessary to provide rail service. Each situation would be different. With multiple carriers operating over the same territory, operating restrictions would also have to be imposed. There would be long hearings and appeals to settle these matters. This would be a disaster.

I do not mean to suggest that one could never envision a situation where the entry of a new carrier would be warranted. Service rendered by a particular railroad could deteriorate to such an extent that this would be appropriate, and several emergency service conditions have been required over the years. But such relief should be available only where there is a clear showing that the primary carrier is incapable of providing the service, and of course with appropriate compensation paid to that carrier.

To achieve the "competitive access" that some seek, perhaps our rail system should be nationalized and made available to any entity seeking access to it. In some ways, this would be a more honest approach. There is a model in Great Britain, where two monopolies have resulted from the privatization of the rail network -- one owning the roadbed and the other providing the service. We could do that, but we then should realize that the federal government must be prepared first to buy the system and then to set the price for entry onto it, as well as to expend the revenues necessary to maintain tracks, bridges, dispatch centers, signals, and the like.

On the other hand, "open access" advocates might be indirectly suggesting application of the antitrust laws instead of the special statutory regime that has been adopted for railroads. Under this approach, there would be no maximum rate regulation with open access. The "public interest" and other factors would no longer be relevant to merger analysis; instead, "competitive access" issues would be considered within the context of the Sherman Act, and mergers would be handled under the Clayton Act.

Let me be clear. I believe that "open access" is a backdoor nationalization of the rails. I do not advocate either such a nationalization of our rail system or the application of the antitrust laws as I have described. But these appear to be the logical conclusions -- perhaps the only logical conclusions -- of the position advanced by the "open access" advocates.

Allow me to offer some other thoughts on "open access". In some cases, carriers have agreed to share tracks or other assets in certain markets. CSX and Norfolk Southern, for example, have agreed to share assets in New Jersey as part of our effort to acquire Conrail. We offered this proposal because it makes sense from a business standpoint. But "competitive access" promoters suggest that our agreements are an indication that the system needs fixing and that the government should

impose these results, or that we only want "open access" when we negotiate it. It is one thing when businesses voluntarily undertake such obligations: value is given and value is received. It's quite another when government mandates the result, for then value is merely taken. The industry makes these decisions when they are economical, and absent an emergency situation the government should not be asked or expected to intervene.

In addition, some who promote "open access" in the electric utility industry suggest that, if it works there, it will work for the railroad industry too. I fundamentally disagree that analogies can be made between these industries. Unlike the electric utilities, the government never awarded a monopoly to the railroads. And there are other differences between the industries. Nonetheless, while the debate rages on Capitol Hill and elsewhere about whether "open access" should be applied to electric utilities, I can state definitively that mandating "open access" in the rail world will not work. Requiring one carrier to permit others to use its facilities at a price below the owning railroad's full costs, as the advocates suggest, would deny railroads the ability to price their service as does every other American business, and prevent the railroads from recovering their investment costs. And if we can't do that, then capital will stop flowing to this industry.

The chorus has grown quite loud, and one might think there is a groundswell of support for forced access. The opposite is true. Many shippers supported deregulation and oppose making major changes to the current law because they experience the benefits of the deregulated world. Intermodal shippers, the fastest-growing segment of rail shipping in America, have prospered because deregulation has provided them with a competitive rail alternative to trucks. Rail users know that, if the "competitive access" advocates prevail and railroads are compelled to charge government-mandated rates to one group of shippers, other rail shippers will suffer.

But "forced access" is not the only proposal which seeks to alter the regulatory structure that has been successful for two decades. Those who have a reregulatory agenda have even persuaded some in Congress to introduce legislation to achieve their goals, including repeal of the Board's "Bottleneck" decision. While their campaign may have a superficial appeal to some, we should not misunderstand its import. This legislation will take us back where we have already been, to a world of stifling rules and crumbling rail infrastructure. The justifications offered in support of reregulation simply don't withstand scrutiny. We don't need slogans or thirty-second soundbites; we need sound economic analysis. Good economics tells us that it is less costly for market demands to dictate

outcomes, for providers and customers to negotiate fair terms of carriage, and for railroads to be able to streamline their operations as necessary.

The genius of the law today is that it delicately balances the legitimate interests of shippers in having dependable service at fair rates with the understandable interest of the carriers in being able to earn sufficient revenues to reinvest in their highly capital-intensive infrastructures. Fundamental changes to the current system are not necessary. I fully support the Board applying the law vigorously when appropriate to protect shipper and carrier interests, and the public. But we should not change the essential nature of the Board's functions. Making some of the legislative modifications that are being discussed would transform the Board from a neutral dispute-resolution body into an advocate for shipping interests. That is ill-advised, and unnecessary. The Board possesses sufficient authority to act when circumstances require. In response to the Interstate Commerce Commission Termination Act, you have already taken a number of significant steps, including accelerating the pace at which rate reasonableness cases are decided and devising a new remedy for small shipment cases.

A continuing challenge for railroads is to improve service to our customers. Shippers need to have dependable transport of their goods, at fair rates. In recent months, as I mentioned earlier, our industry has been

struggling with service issues on the Union Pacific system. This Board has taken a measured and appropriate approach to assist the rail industry to work through this situation. The problems are real, and have to be fixed. Before deregulation, it is honest to say that such service problems likely would not have been so noteworthy, since the rail freight system wasn't relied on as a critical part of our Nation's transportation infrastructure. However, in today's deregulated world, customers have come to expect quality freight rail service, and nothing less should be acceptable to us or to them.

There are no simple solutions. We must do a better job of coordinating with our customers to anticipate demand, and to provide the needed cars to transport their products. CSX and Norfolk Southern have been planning for the integration that will be required if our proposal to acquire Conrail is approved. CSX, for example, has made vigorous efforts to assure adequate locomotive power. We have acquired 189 new units, and rebuilt about 120 engines that we otherwise would have retired at the end of next year. We also are compensating Conrail to hire additional employees in case they are needed, and we are training our employees so they will be ready to implement the new system smoothly. At CSX, we have improved service and reliability, but I freely admit that we must go much further. And we will. But the free flow of capital to support these

efforts must not be choked off by efforts to micromanage the industry through reregulation.

Commissioner Owen, we agree with your observation in the Bottleneck decision that, "more efficient solutions to all shipper-carrier disputes are to be achieved in the marketplace and through direct negotiations without the intrusion of government."⁹

We are striving toward that goal. CSX, Norfolk Southern (NS), and the National Industrial Transportation League (NITL) recently agreed to establish the new Conrail Transaction Council. The Council will be comprised of representatives of CSX, NS, the NITL, and other organizations representing affected rail users, to serve as a forum for dialogue and the dissemination of information about operations in the new rail system in the East. This is a voluntary effort by the carriers and shippers, one not required by the government but intended by the participants to assist in facilitating the working relationships between CSX and NS, and our respective customers.

⁹ Comments of Commissioner Owen in *Central Power & Light Company v. Southern Pacific Transportation Company* No. 41242, *et al.*, (Decision of Surface Transportation Board, Dec. 27, 1996).

We have seen the fruits of deregulation, and it would be disastrous to return to excessive government regulation. Senator Russell Long, Chairman of the Surface Transportation Subcommittee, observed almost twenty years ago, "where there is adequate and effective competition there is no need for regulation."²⁷ If reregulation is imposed, railroads will have to forgo market-pricing in favor of rates and rules set by the government. High capital costs that are inherent in the rail industry will not be recovered, jeopardizing further investment in technology and equipment. Congressman Edward Madigan referred to the effects on his rural constituents of the stifling regulatory environment in place in 1980 (when the Staggers Act was enacted) when he commented that, "one of the reasons our national railroad system is in such poor condition is the fact that regulation has prevented aggressive competition."²⁸ Just two years ago, when the ICC was sunsetted and this Board was constituted, Congress reviewed the deregulated rail system and rejected calls to reregulate. We cannot go back to that regulated world.

Madam Chairman, Vice-Chairman Owen, those who do not remember history are doomed to repeat it! After all the slogans; after all the rhetoric by the naysayers, some of whom are the same voices who

²⁷ 125 Cong. Rec. S15320 (daily ed. October 29, 1979) (statement of Sen. Long).
²⁸ 126 Cong. Rec. H5901 (daily ed. June 30, 1980) (statement of Rep. Madigan).

opposed deregulation 18 years ago; after all the inflated claims of how the rail world will be improved if we just go back to having the government make the decisions; after all that, one thing is clear -- deregulation is working. We must continue to allow market forces, with appropriate governmental safeguards, to operate.

That is the proud history of the past two decades, a history forged by leaders in the transportation world, in Congress and in this agency. I believe the Board has been a major contributor to that success, working cooperatively with carriers, shippers, labor and governmental entities to further the positive changes that are occurring, and I am confident the Board will continue to play a pivotal role in seeking solutions that are consistent with the balanced approach that has been its hallmark. The Board's administration of the law has justly earned the acclaim of the financial and economic communities. I pledge my efforts and those of all the employees of CSX toward continuing the positive trends in our industry, so that the next 100 years of railroading are characterized by competitive behavior, first-class service, and the safe and efficient carriage of goods.

COMMONWEALTH OF VIRGINIA)
CITY OF RICHMOND) SS.

VERIFICATION

John W. Snow, being duly sworn, deposes and says that he is Chairman, President and Chief Executive Officer of CSX Corporation, that he is qualified and authorized to submit this Verified Statement, and that he has read the foregoing statement, knows the contents thereof, and that same is true and correct.

John W. Snow
John W. Snow

Subscribed and sworn to before me by John W. Snow this 25th day of March, 1998.

Louis H. Becker
Notary Public

My commission expires:

COMMONWEALTH OF VIRGINIA)

CITY OF RICHMOND)

SS.

VERIFICATION

John W. Snow, being duly sworn, deposes and says that he is Chairman, President and Chief Executive Officer of CSX Corporation, that he is qualified and authorized to submit this Verified Statement, and that he has read the foregoing statement, knows the contents thereof, and that same is true and correct.

John W. Snow
John W. Snow

Subscribed and sworn to before me by John W. Snow this 25th day of March, 1998.

Louis H. Parker
Notary Public

My commission expires:

GOODE

Verified Statement

of

David R. Goode

My name is David R. Goode. I am Chairman, President and Chief Executive Officer of Norfolk Southern Corporation. Before assuming my present position in 1992, I held a succession of management positions with Norfolk Southern and its rail carrier predecessors. I have had more than 31 years of experience in the railroad industry.

I understand that at the request of Congress the Surface Transportation Board has commenced this proceeding to review access and competition issues in the rail industry. For the reasons elaborated below, I believe that at this critical juncture in the industry's history such a review is entirely fitting. There is no better time than now to affirm the central importance of the deregulatory project Congress started in the rail industry two decades ago. Looking ahead, we need the reform-minded principles of the 4-R Act and the Staggers Act more than ever to deliver safe, service-oriented rail transportation. Our customers are depending on it.

Past Successes and Present Challenges

There will be much said in this proceeding, by railroads and we hope by some rail customers, about what railroads have accomplished under deregulation. Rail freight volume has increased 40 percent, while average rail rates have fallen for all major commodity groups and in all geographic areas. Train accidents have declined almost 70 percent. Productivity of physical assets -- freight cars, locomotives and track -- has doubled, while labor productivity has tripled. Return on investment has increased from less than 2 percent in the 1970s to as much as 9 percent in recent years.

These are impressive achievements for an industry that was in trouble when the reform movement started. Yet somehow the achievements seem rather hollow in light of the recent crisis in the West. As with any business, it is railroads' obligation *continuously* to earn customer satisfaction, and there is no minimizing the challenges we face in regaining customers' confidence once service levels have been restored.

But is there something systemically wrong with competition and access in the rail industry? That is a different question, and one that must be answered with a view to the long term. To do so it is worth recounting how the deregulatory initiatives of the 4-R Act and Staggers Act, and the ICC and STB decisions implementing those reforms, gave railroads the opportunity to compete effectively with other transportation modes for freight traffic, and allowed them to reduce operating costs, improve service, and strengthen the industry's financial health. These are the regulatory fundamentals that can usher in a new era of growth, just as they helped the industry return from the brink of collapse.

Business Basics

Ratemaking freedoms allowed us to adjust rates for particular commodities and shippers on the basis of individual market conditions. That sounds like business at its most basic, but to a pervasively regulated industry it was a revolution. The freedom to price in accord with market signals meant we could compete for traffic that otherwise would not move by rail. Being able to differentiate rates on the basis of demand brought increased volumes of all types of competitive traffic, and thus greater density and a greater contribution to fixed and common costs that otherwise would have to be borne by less competitive traffic.

We rationalized our physical network and route structure to become more efficient. We eliminated, or transferred to entrepreneurial, lower cost operators, duplicative or low-density

lines, while concentrating as much traffic as possible on high-density trunk lines. We acted to close inefficient joint-line routes, and to concentrate interline traffic at high volume, efficient interchange points. We eliminated the delays associated with unnecessary interchanges. Mergers increased single-line service and thus increased the average length of haul.

Rate and routing flexibility enabled us to improve direct service to shippers. Longer hauls translated into increased ability to control the timing and coordination of shipments, thereby ensuring prompt delivery of freight and increased equipment utilization. Through the use of transportation contracts, we tailored service to the specific needs of our customers.

Finally, we took advantage of rate and routing freedoms to invest in capital maintenance and improvements that allowed us to improve service, expand capacity and achieve operating efficiencies. The ability to set rates based on market conditions made it possible to justify this investment. Again, it was just business basics, but none of it would have been possible without the deregulatory revolution Congress unleashed when the industry was fighting for its life.

What Is Now Possible

With twenty years of reforms behind us and relative financial stability, consider the kinds of capital investments now possible on just one railroad, Norfolk Southern. NS' planned 1998 expenditures for capital improvements are \$903 million. That is a lot of money, and it is all going to enhancements that will benefit our rail system's users.

Initial expenditures for facilities and equipment related to our proposed operation of a large part of Conrail will total \$149 million. Much of this is for investments in technology and improvements to increase capacity, such as construction or extension of passing sidings and double-tracking portions of key routes. Of the balance, \$279 million is for the rail, crosstie, ballast and bridge replacement programs. \$237 million is for the purchase of 116 six-axle,

high-adhesion locomotives and new freight cars, including multilevel automobile racks, high-cubic capacity boxcars for automotive parts, covered gondolas for coil steel, billet flatcars for steel, centerbeam flatcars for lumber and small-cubic capacity covered hoppers.

In addition to the investments in new equipment, NS expects to spend more than \$44 million to support our ongoing program to get better utilization of existing equipment. This includes the continuing coal car rebody program; modifying gondolas to increase the capacity of the scrap metal fleet; rebuilding high-cubic capacity auto parts boxcars; and improving segments of the automotive multilevel fleet. NS' 1998 capital budget also includes the initial phase of the following multi-year projects:

- * \$56 million for track projects, primarily for Conrail-related work on NS;
- * \$47 million to replace pole lines with electronic track circuits and data radios, \$26 million of which is for the NS line between Buffalo and Cleveland;
- * \$47 million for computer hardware and software projects, including \$25 million related to the Conrail transaction;
- * \$21 million for communications projects, \$17 million of which is Conrail-related; and
- * \$19 million for new or expanded intermodal and bulk distribution facilities on NS.

These investments, and the direct benefits to safety and service they will engender, demonstrate what is possible when railroads are financially stable and capable of investing for the future.

Deregulatory Revolution or Regulatory Devolution?

It is scarcely exaggeration to call some of the proposals relating to competition and access

a broadside attack on enlightened deregulatory policy. Proposals that, for example, would codify into law the ability to override carriers' routing initiative would undermine, if not reverse, the progress railroads have achieved in financial health, service quality and competitive ratemaking. They would roll back railroads' ability to make additional, pro-competitive capital investments necessary to maintain and improve service. And they would re-establish intrusive government involvement in the minute details of railroad rates, routes, divisions and operating practices. In short, they would convert the deregulatory revolution into unenlightened regulatory devolution.

Can railroads and their customers afford this? Even in ordinary times railroads require massive and ongoing infusions of capital, much of which is tied up in fixed assets. And these are not ordinary times. To fix western service problems and carry out eastern rail restructuring, we will need capital. Over the long term, we will need to accustom ourselves to growth and that will mean strategic deployment of additional capacity. Railroad traffic in certain commodities, like intermodal and western coal, has been growing for decades, but the overall surge of demand for rail transportation in other commodity groups and in all regions of the country is a new phenomenon. To meet this demand we will have to shift gears and assume that growth is the norm.

If through reregulation we end up consistently short-hauled or forced to route traffic inefficiently, we will not meet the challenge. Instead of growing we will have to reduce capital expenditures. This will mean less traffic on the rails and more on the highways. With less capital we will be unable to commit the resources necessary to attract new traffic, and will face potential loss of existing traffic.

There will be a ripple effect. With fewer carloads on a given line or on a given train, the contribution each carload must make to cover the cost of the line or the train will rise. Traffic

that is only marginally profitable will become unprofitable and we will no longer be able to afford to carry it. This is the state the industry was in before deregulation, and fundamental railroad economics have not changed. We cannot afford a declining traffic base and begin again the destructive spiral that took the last twenty years to reverse.

A Simple Litmus Test

To avoid regulatory devolution we need only apply to any proposal for forced access a simple, three-part litmus test, derived from the common-sense principles that govern competition and access in the rail industry today:

Does the proposal inhibit the carrier's ability to control routing, including interchange, and optimize network efficiencies?

Does the proposal inhibit the carrier's ability to manage its network by concentrating traffic on high-density lines and eliminating or transferring duplicative or low-density lines?

Does the proposal inhibit the carrier's ability to price differentially and thereby spread fixed costs among the most network users?

Measures that would alter the rules of competition and access in the rail industry that fail these simple tests -- and most do -- are at odds with the wise deregulatory framework Congress established twenty years ago and should be soundly rejected.

Deregulation's Central Accomplishment

Rather than proclaiming the dawn of a new era, I would prefer to be announcing unequivocally in this statement that the new era had arrived. But even if the western service crisis had not occurred and there were no need to qualify our assessment of past achievements, I suspect I would be filing this statement. Indeed, if railroads' post-deregulation track record were unblemished, it probably would be all the more necessary to come to the defense of the

deregulatory revolution, because it would have been all the more successful. And success, for those whose strategy is to coopt the regulatory process for parochial gain, signals opportunity.

But what is an opportunity for the few can be a hazard for the many. To dismantle the existing framework of competition and access in the rail industry would be to ignore, and to place at risk, what is, perhaps, the central accomplishment of that framework. It is an accomplishment of clear advantage to rail customers: rail transportation prices have declined dramatically. Just a few weeks ago the STB reported that the average real rate has fallen 46.4 percent between 1982, two years after the Staggers Act, and 1996. According to one estimate, the gains to the shipping public from rate reductions during approximately this period are measured not in billions but in *tens of billions of dollars annually*.^{*}

Where has this money come from? It has come from railroads' productivity gains. No other rail carrier has proven better than Norfolk Southern that more efficient operations are consistently achievable.^{*} But we may be at the point where incremental improvements, not dramatic productivity breakthroughs, are the order of the day. In such a situation, to impose still greater revenue pressure on railroads is to threaten the integrity of the rail transportation network.

Real Competition and Access in the New Era

Ironies abound in the current regulatory environment, not least of which is the fact that some can claim there is not enough competition and access when we are on the verge of the most pro-competitive, pro-access restructuring in railroads' history: the Conrail transaction. The balanced structure of East and West that will emerge, coupled with networks and partnerships with regionals and shortlines, will establish the basis for a shipper-friendly and strongly

^{*}Carl B. Martland, "Sources of Financial Improvement in the US Rail Industry, 1966-1995," Proceedings of the Transportation Research Forum, 39th Annual Meeting (1997), at 77.

competitive rail transportation system. That system will feature real competition, as two balanced rail networks compete against each other and motor carriers, not the illusory competition for the benefit of the few that reregulation would produce.

Conclusion

I urge Congress and the STB to uphold the sound economic principles that have guided the rail industry's renaissance. We have our problems and challenges, to be sure, and they must be addressed if the industry is to prosper in the future. But we also have our successes, and I include in "we" the Congress, the ICC, the STB, the railroads, their customers and all industry stakeholders. Among these successes few can surpass the visionary deregulation that established modern ground rules for competition and access and set the rail industry on the right course twenty years ago.

VERIFICATION

COMMONWEALTH OF VIRGINIA)
) SS:
CITY OF NORFOLK)

DAVID R. GOODE, being duly sworn, deposes and states that he has read the foregoing
Verified Statement, knows the facts asserted therein and that the same are true as stated.


DAVID R. GOODE

Subscribed and sworn to before me,
a Notary Public in and for the
State and City aforesaid, this
2nd day of March, 1998.


NOTARY PUBLIC

My commission expires:

MARCH 31, 1998

[SEAL]

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^{*}Carl B. Martland, "Sources of Financial Improvement in the US Rail Industry, 1966-1995," Proceedings of the Transportation Research Forum, 39th Annual Meeting (1997), at 77.

DAVIDSON

VERIFIED STATEMENT

OF

RICHARD K. DAVIDSON

I am Richard K. Davidson, Chairman and Chief Executive Officer of Union Pacific Corporation and Chairman of Union Pacific Railroad Company. I have been a railroader for 38 years, since I began my career as a brakeman/conductor with Missouri Pacific in 1960. I held a series of operating positions with Missouri Pacific, and then, following the UP/SP merger in 1982, with Union Pacific. I became CEO of Union Pacific Railroad in 1991, and of Union Pacific Corporation in 1997.

As the Board well knows, Union Pacific is struggling with a service crisis. That crisis was unexpected, and the great difficulty we have had in overcoming it has been even more unexpected. The crisis has been costly for our customers, and it has been costly for UP, which after years of uninterrupted profits faces a second straight quarter of losses as we pour resources into solving our operating problems.

I am acutely embarrassed, and our company is embarrassed, at the time it has taken to recover from our congestion crisis. We had absolutely nothing to gain from projecting a faster recovery than could be accomplished. Decades of prior experience told us that our projections were correct. But reality has been telling us something else. We

have learned in the most painful possible way a lesson that is of critical importance in the present proceeding. That lesson is that the railroad industry faces a severe capacity problem.

Year after year, the railroads have been increasing their traffic volumes without adding commensurately to their physical capacity. Some, like cash-strapped Southern Pacific, actually reduced physical capacity in areas where traffic was burgeoning, such as the Gulf Coast chemical complex. The railroads were able to do this by deploying new systems and technologies that increased the efficiency of railroading at the same time as personnel and even physical infrastructure were cut back.

But what we did not realize is just how vulnerable to extraordinary stresses our streamlined railroads, confronted with demands to handle more and more traffic with greater and greater levels of service quality, had become. We no longer had the vital cushion -- the surge capacity -- to cope with the kinds of multiple stresses that swamped Southern Pacific in the Houston/Gulf area last summer.

Much of the immediate solution to Union Pacific's congestion problem lies in completing the process of realizing the efficiencies of the UP/SP merger in Texas and the surrounding states. Achieving this in the midst of severe service disruptions has been a terrible struggle -- but we have had no choice. Only with the capacity-creating effects

of directional running, yard specialization and increased pre-blocking can we be confident of smoothly handling the high levels of business demand in this area. Indeed, one of the great ironies of this unhappy time has been the attempt of those who opposed the merger to blame the merger for our service problems. When SP was engulfed by the Gulf Coast congestion crisis last summer, pulling UP down with it, we had not merged the railroads in the Gulf Coast area: if we had, this crisis would never have happened.

But the merger is not the complete answer. It is also now clear that in order to reach a lasting solution to the congestion problem and be sure it will not recur, we must increase our already very substantial plans for investment in physical infrastructure. As the Board knows, Union Pacific is stepping up to that challenge. We recently made the difficult decision to cut our dividend for the first time in many years, and we are in the process of raising a billion dollars in additional liquid funds in order to be able to fully satisfy the capital demands of our business. We are conducting a comprehensive analysis of the physical infrastructure needs of the Union Pacific system in the Gulf Coast area, and we are going to invest what it takes to meet those needs.

This brings me to the subject of the present proceeding: whether the government should try to inject artificial, additional "competition" in the rail industry

through compulsory access schemes, mandatory "bottleneck" rates, or similar measures.

All such proposals are really aimed at one thing: destroying the ability of railroads to set their prices differentially, on a marketplace basis. Many shippers do not support such proposals. Those who do hope to achieve gains from forcing rail rates down. But any such gains, even for the minority of shippers who might benefit, would be short-term only.

In the long run, if railroads cannot price differentially and rates are forced down to or near variable costs, railroads will be unable to cover their full costs, including the cost of providing a return on invested capital. And if a railroad cannot cover all of its costs, including earning enough to provide a competitive return on invested funds, investors will not provide such funds. UP and the rest of the industry will not be able to meet the challenge of building new infrastructure to handle the traffic of a growing economy. Instead, the railroad industry will shrink, and the American economy -- and all rail shippers, including those short-sighted enough to support compulsory access measures -- will be the losers.

Before the Staggers Act was enacted, the rail industry was condemned by regulation to woefully inadequate returns. The railroads suffered year after year of

disinvestment. The owners of rail assets preferred to diversify into amusement parks rather than invest in maintaining and improving their rail facilities.

Staggers substantially deregulated the rail industry, and made it realistic for investors to expect that the railroads could earn adequate revenues. The industry has in fact made steady progress toward revenue adequacy. As a result, UP and other major railroads have invested heavily throughout the 1980s and 1990s. Between 1981 and 1997, the railroads now combined in the Union Pacific system invested more than \$31 billion, in 1997 dollars, in their rail operations. In many years, UP invested more than we earned. Far from diversifying out of railroading, we have focused our business more and more on our core railroading function. This has been possible only because of deregulation, the freedom to price our business compensatorily, and the realistic prospect of revenue adequacy.

All of this will change overnight if this industry is re-regulated in the guise of promoting "competition." Compulsory access or "bottleneck" rate schemes do not create genuine competition: they try to force artificial competition -- which is by its nature unsustainable, and thus illusory. They would force more competitors into markets in the short run, but their long-run impact would be to destroy the very competition they are ostensibly aimed at promoting.

What few people seem to understand is that the present structure of our railroad industry reflects genuine competition. Railroads never had a franchise monopoly like electric utilities or telephone companies. Railroads were built by private capital where the capital markets saw a prospect for compensatory returns. This continues to occur even today -- for example, in the Powder River Basin project and in build-outs by major shippers such as Houston Lighting & Power. Many markets are served by more than one railroad, but where they are not, it is not because the government granted the railroads a monopoly; it is because demand was insufficient to induce private capital to build multiple railroads to serve them.

If all those one-railroad markets -- which are vital to our ability to price differentially and thereby cover our costs -- are forced by governmental fiat to be two-railroad markets, that is not competition, it is regulation. Competitive capital markets did not produce universal two-railroad service. Artificially forcing such service through governmental directive will only destroy the viability of the railroads, and thereby destroy the sustainable competition that now exists.

Some of the arguments one hears in the "competition" debate are downright dishonest. For example, it is just not true that railroad mergers have caused customers to become

"captive" to railroads. In fact, this Board, and the ICC before it, have been scrupulous to preserve rail-to-rail competition through conditions where mergers would have eliminated it. The UP/SP merger decision illustrates that very dramatically: not only were we required to provide BNSF access to every existing "2-to-1" facility; we were also required to provide access to all transloading facilities and new facilities wherever BNSF received trackage rights, and to preserve pre-existing build-in options. So when inveterate merger critics like the Texas Railroad Commission say that the answer to our service problems is to restore the "competition" that the merger supposedly extinguished, they are doubly wrong: our merger did not eliminate rail competition for any shipper; and the last thing that is needed to overcome the congestion we have been struggling with is to add another railroad to switch shipper plants and interchange traffic in the middle of the congested areas.

I know how unpopular these truths are at this time of crisis. For a shipper who has no practical choice but to use Union Pacific service, the siren song of "competition" is very attractive. In fact, during the congestion crisis, we voluntarily worked with our customers to open short-haul interchanges and suspend contracts so that, where it would not affirmatively worsen our congestion problems, they could get their traffic onto other railroads. The Board imposed certain

additional, focused measures along these lines. But the hard fact is that we have a congestion and capacity crisis, not a competition crisis. Imposing more "competition" in the form of compelled access will worsen our operating difficulties as well as undermining our long-term financial health.

Union Pacific, like all the major railroads, faces intense genuine competition. Much of our traffic is competitive with other railroads, through direct service, reciprocal switching, competing intermodal and auto ramps, truck-rail handling, and transloading. Build-ins regularly expand this universe, as do shipper decisions to relocate or open new plants. Trucks and barges also compete powerfully for much of our traffic. Product and geographic competition impinges sharply on us. Developments like the deregulation of electric power wholesaling give major shippers enhanced leverage over us.

All in all, the railroads are on an accelerating competitive treadmill, struggling to improve our productivity faster than the continued declines in our rates. As we confront today's capacity challenge, there can be no assurance that we can stay ahead in this race. Re-regulation -- even in the face of shipper distress over an unprecedented congestion crisis, and even in response to the deceptive siren song of artificial "competition" -- will only guarantee that we lose that race, with incalculable damage to our nation.

VERIFICATION

COMMONWEALTH OF MASSACHUSETTS)
COUNTY OF Suffolk) ss:

I, Richard K. Davidson, being duly sworn, state
that I have read the foregoing statement, that I know its
contents, and that those contents are true as stated.

Richard K. Davidson
RICHARD K. DAVIDSON

SUBSCRIBED and sworn to before
me this 23rd day of March, 1998.

Barbara A. Barkin
Notary Public

BARBARA A. BARKIN
Notary Public
My Commission Expires June 14, 2002

ANDERSON

**BEFORE THE
SURFACE TRANSPORTATION BOARD**

STB Ex Parte No. 575

REVIEW OF RAIL ACCESS AND COMPETITION ISSUES

VERIFIED STATEMENT

OF

JOHN Q. ANDERSON

My name is John Q. Anderson. I am Executive Vice President of Sales and Marketing for CSX Transportation, Inc. (CSXT). Prior to joining CSXT in May of 1996, I held the position of Executive Vice President, Marketing and Sales and, later, Senior Vice President -- Coal Business Group at Burlington Northern Santa Fe. I am responsible for all sales and marketing efforts by CSXT. Prior to my positions in the railroad industry, I spent 13 years with McKinsey & Company, where I undertook a wide variety of management consulting assignments, both within and outside the transportation industry.

I am submitting this statement in response to the Board's recent request for comments on issues relating to access and competition in the rail industry. Apparently in response to the serious rail service disruptions that have occurred on the recently merged UP/SP system over the past year and various proposals that have been offered to re-regulate the rail industry (such as proposals for imposition of "bottleneck" rate regulation and forced access to solely

served rail shippers), several members of Congress have asked the Board to undertake an examination of the current state of rail access and competition, and to assess whether any changes in the existing regulatory scheme administered by the Board may be warranted. The Board has sought input on these issues from railroads, shippers and other interested parties.

The purpose of my testimony is to address, from the perspective of a senior railroad sales and marketing officer, four interrelated points that bear on these important issues:

- (1) The remarkable success that the existing regulatory scheme, including the de-regulatory reforms of the 4-R Act and Staggers Act, has enjoyed in allowing railroads (including CSXT) to offer efficient, more competitive service at lower rates to a wide range of shippers, while at the same time improving their financial health and attracting the capital needed to maintain and expand the rail infrastructure;
- (2) The pervasive competition that characterizes virtually all classes of CSXT's rail freight traffic, including traffic that is served at origin or destination by a single rail carrier;
- (3) The uniformly positive impacts that rail merger and consolidation transactions over the past two decades (including those which created the CSXT system) have had in enabling the railroad industry to take advantage of the post-Staggers ratemaking and routing freedoms by rationalizing their rail networks, expanding single-line service, and reducing both the costs of service and overall rate levels; and
- (4) The railroad industry's critical need for adequate sources of capital for investment in needed rail infrastructure, including new investment in expanded capacity to meet the demands of a growing American economy.

are compelled by regulation to charge rates reflecting average or uniform markups over variable costs, the inevitable result is to drive away the more competitive traffic, thereby leaving less competitive traffic to bear a greater share of the industry's revenue needs or forcing the industry to disinvest (which, in turn, drives more traffic away from the system). By contrast, allowing railroads to differentiate their rates has permitted them to attract large volumes of very competitive traffic that make a positive contribution to the railroads' fixed and common costs, and thereby defray the revenue burdens that less competitive traffic would otherwise have to bear if adequate rail service is to be preserved.

These ratemaking freedoms, and the recognition of the need for differential pricing, have given the railroads a much greater incentive and ability to compete effectively against trucks and other low-cost modes of transportation. Railroads, including CSXT, have begun to win time-sensitive and high-value traffic that once moved exclusively by other modes.

Much of the growth in our traffic is attributable to this competitive traffic, which we can attract only because of our ability to offer proportionally lower rates to meet the intense competition we face, particularly from trucks. The most obvious, and dramatic, example is intermodal container and trailer traffic, which has been the fastest growing segment of CSXT's business in recent years. Between 1989 and 1997, intermodal loads over CSXT increased from 713,000 units to 915,000 units.

Even in segments of our business not normally considered truck competitive, such as chemicals, our pricing flexibility has led to success. In the last two years we have mounted a concerted effort to convert chemicals traffic from truck to rail and have been successful in winning over 15,000 carloads annually of chemicals business (in excess of \$20 million annual

I. The Existing Regulatory Scheme Has Been An Unqualified Success For Railroads and the Shipping Public.

It is both worthwhile and necessary to begin any evaluation of the existing scheme of railroad regulation with a review of the effects that this regulatory scheme has had on the rail industry and the shipping public generally. Remember that in the 1960s and 1970s the rail industry was suffocating, strangling on its inability to function as a heavily regulated enterprise in a vibrant and dynamic transportation market. Penn Central and a number of other carriers went under when they were unable to recapitalize their business or respond to customer demands in an increasingly truck-dominated environment. The Staggers Act was a last-ditch effort by Congress to free the railroads to compete. And, compete we have.

The Staggers Act reforms were based on several simple, but powerful ideas. First, and foremost, they reflected the idea that rail rates and service should be based on market conditions and the demand for service, with only limited regulatory scrutiny for those relatively rare instances in which railroads do not face effective competition and have engaged in competitive abuses. Essential to this principle was the recognition that railroads face intense competition for most categories of freight traffic. Railroads must tailor their rates to market conditions and be able to differentiate rates on the basis of demand if they are to have any chance of earning revenues adequate to maintain and replace their substantial fixed investment over time.

This system of differential pricing -- charging less-than-average markups over variable costs for more competitive traffic and greater-than-average markups for less competitive traffic -- is absolutely essential to the railroads' ability to cover their full economic costs of service, including their cost of capital. As the experience of the pre-Staggers era reflects, when railroads

are compelled by regulation to charge rates reflecting average or uniform markups over variable costs, the inevitable result is to drive away the more competitive traffic, thereby leaving less competitive traffic to bear a greater share of the industry's revenue needs or forcing the industry to disinvest (which, in turn, drives more traffic away from the system). By contrast, allowing railroads to differentiate their rates has permitted them to attract large volumes of very competitive traffic that make a positive contribution to the railroads' fixed and common costs, and thereby defray the revenue burdens that less competitive traffic would otherwise have to bear if adequate rail service is to be preserved.

These ratemaking freedoms, and the recognition of the need for differential pricing, have given the railroads a much greater incentive and ability to compete effectively against trucks and other low-cost modes of transportation. Railroads, including CSXT, have begun to win time-sensitive and high-value traffic that once moved exclusively by other modes.

Much of the growth in our traffic is attributable to this competitive traffic, which we can attract only because of our ability to offer proportionally lower rates to meet the intense competition we face, particularly from trucks. The most obvious, and dramatic, example is intermodal container and trailer traffic, which has been the fastest growing segment of CSXT's business in recent years. Between 1989 and 1997, intermodal loads over CSXT increased from 713,000 units to 915,000 units.

Even in segments of our business not normally considered truck competitive, such as chemicals, our pricing flexibility has led to success. In the last two years we have mounted a concerted effort to convert chemicals traffic from truck to rail and have been successful in winning over 15,000 carloads annually of chemicals business (in excess of \$20 million annual

revenue) that formerly moved by trucks. In most instances where we have failed to win the business, it was due to reasons other than price.

CSXT today is handling record traffic volumes across many different commodity groups. As I shall discuss further below, most of this traffic is subject to intense competition from a variety of sources. The simple fact is that we could not attract this traffic without the ability to differentiate our rates on the basis of market conditions and the demand for service.

A related feature of the current regulatory scheme established under Staggers is the ability of railroads and shippers to negotiate private, unregulated transportation contracts specifying individual rates and service terms. Today, the large preponderance of CSXT's freight traffic, and over 95 percent of our coal traffic, moves under contract (or is otherwise exempted from regulation). These arrangements offer substantial benefits for both railroads and shippers. In particular, long-term contracts, by locking in commercially attractive rate levels, give railroads the assurance and certainty of future traffic volumes and revenues necessary to justify service-related capital investment, including freight cars and locomotives, rail sidings and lead tracks, and loading and unloading facilities. For their part, shippers also enjoy the benefits of protected rate levels (often secured in exchange for tonnage commitments), which also facilitates their capital planning efforts. Shippers also use contracts to obtain from us assurances regarding equipment supply and service levels. None of these benefits would be possible if shippers had ready resort to an intrusive system of rail rate regulation.

A third fundamental principle underlying the de-regulatory reforms of Staggers is the notion that railroads should be given the flexibility to manage their business by establishing efficient routings of traffic. Staggers ended the era of forced interchange, where it was presumed

that a carrier should be obligated to offer service over any cobbled-together route that could conceivably be constructed. Taking advantage of rail mergers and consolidations (such as the Chessie-Seaboard merger that created CSXT) that expanded the size and scope of individual carriers' networks, railroads (including CSXT) began to route traffic more efficiently, consolidating traffic over more direct routes and through more efficient yards. Railroads have succeeded in consolidating traffic to increase density in some corridors, achieving maximum use of available locomotive power and track. Track structure on key lines has been upgraded and service has been enhanced.

Finally, freed from regulation-imposed constraints on railroad routing practices and given partial de-regulation of railroad rates, the railroads have rationalized their networks through efficient inter-carrier agreements, such as trackage rights, reciprocal switching and haulage arrangements. Railroads have every incentive to enter into such pro-competitive arrangements, provided that they are operationally feasible and do not impair the carriers' ability to charge rates that cover the full economic costs of service. In simple terms, if railroads can offer more efficient service, at lower cost, through the use of another carrier's lines, all interested parties -- carriers and shipper alike -- have a strong interest in implementing access arrangements. To cite but two examples, CSXT and Norfolk Southern several years ago entered into a series of interrelated agreements (including reciprocal trackage rights) to rationalize each carrier's operations and routes in South Carolina and, in connection with the proposed joint acquisition of Conrail, those carriers have provided for unprecedented joint access to the portions of the Conrail system designated as shared assets areas. These kinds of arrangements are pro-competitive, and benefit all shippers. However, these arrangements are possible only under a scheme of regulation that

gives railroads substantial pricing and routing flexibility, the ability to command (if market conditions permit) revenues sufficient to generate a competitive rate of return, and the ability to make voluntary, efficiency enhancing business arrangements that recognize all parties' fundamental economic interests. They cannot be successfully imposed or implemented by government fiat.

Railroads have responded to the regulatory flexibility that was extended to them under these reforms. Relying on the promise of rate freedoms in making its capital investments, CSXT has invested over \$8.9 billion (exclusive of repair and maintenance expense) in the post-Staggers era -- an amount that management in the late 1970's would never have dreamed possible. Much of this investment has been directed to new plant and facilities designed to attract competitive freight traffic, including substantial investments in new rolling stock, double-tracking of rail lines, construction of new intermodal loading ramps and bulk truck transload facilities, improved dispatching, signaling and shipment tracking systems, and other projects.

The result of the rail industry's efforts under the de-regulatory freedoms made available by the Staggers Act and implementing decisions has been an extraordinary success for railroads -- and for the shipping public. Mr. Ward, CSXT's EVP Finance, describes in his separate statement the financial performance of CSXT in the era of competition and describes in detail the capital investment and maintenance expenditures that have been made to revitalize and improve the CSXT rail network. I would like to discuss what this means for CSXT's customers.

A modern logistics manager is looking for five things from a transportation provider:

- * safety
- * damage-free delivery
- * prompt, reliable transportation service
- * supporting information technology
- * competitive prices

CSXT has made remarkable strides in all these areas.

Train accidents per million train-miles were down from 13.6 in 1980 to 2.25 in 1996.

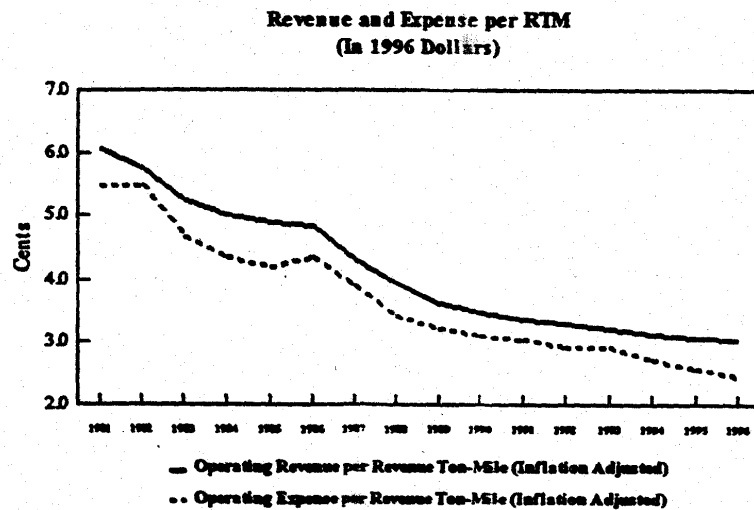
Loss and damage as a ratio per \$100 of freight revenue was down from 34 cents in 1986 to 19 cents in 1997, for a cumulative percentage reduction of 44.1%.

CSXT has placed a growing emphasis on running the railroad to plan. We have organized many of our operations around service lanes as a means of focusing on reliability. We have created geographic business units with tremendous operating and marketing autonomy for the purpose of focusing on the customer's needs. We are dedicating more and more effort to improving the reliability of our service.

CSXT's ability to track freight cars throughout our system and to advise customers of their location and estimated time of arrival at destination has improved remarkably through the use of computer technology.

All these successes have been accomplished during the era of competition, even as prices have fallen. CSXT's rates, adjusted for inflation, have fallen almost constantly since 1980,

generally tracking the substantial reductions we have experienced in rail operating expenses. Revenue on a revenue per ton-mile basis is down about 50 percent since 1981 on an inflation-adjusted basis.



Even coal shippers, who have been among the most ardent exponents of re-regulation, have shared in these rate reductions. Between 1981 and 1996, CSXT's coal rates declined approximately 50 percent, on an inflation-adjusted basis. Even without adjusting for inflation, CSXT's average coal revenue per ton-mile is down approximately 17 percent in the period from 1981 through 1996.

Competition has forced the railroads to provide a better product at a lower price. The downward slope in prices tracks the downward slope in unit costs as railroads have squeezed costs from the system and become more efficient. With enhanced efficiency, railroads have, in a competitive environment, been forced to bring rates down as well.

The most basic message of this statement is that railroads have reduced costs and competition has forced them to pass those savings on to customers -- including shippers of coal and other commodities that are predominantly rail-served or that originate or terminate at points exclusively served by a single railroad. These benefits are directly attributable to the de-regulatory reforms that have been implemented since the Staggers Act.

II. CSXT Faces Intense Competitive Constraints For Virtually All Categories of Rail Freight Traffic.

Regulation of carrier rates, service and routing practices can be justified only when necessary to prevent anti-competitive abuses. It is therefore entirely appropriate for the Board to seek comments on the current degree and effectiveness of competition in the rail industry in connection with consideration of possible changes in the existing scheme of rail regulation. As a railroad marketing officer, I want to assure the Board that competition is flourishing in the rail industry today. CSXT faces fierce competitive pressures, from a variety of sources, for virtually every category of freight traffic we handle -- including traffic that originates or terminates at points served by only one railroad. This competition has become ever more intense in recent years, particularly as CSXT and other railroads become more efficient and as increasing competitiveness in the global economy forces our shippers to reduce their costs, including transportation costs.

It remains true, however, that much of the freight traffic that is handled by CSXT (and other railroads) originates or terminates at points that are exclusively served by only one railroad. Shippers at such locations often like to characterize themselves as "captive," a pejorative term intended to suggest that the affected shipper has no effective competitive leverage and that the serving railroad is free to extract monopoly profits unless restrained by regulation. But this is not the case for the vast majority of them. This should be obvious from the fact, which I just discussed, that railroad rates have fallen significantly in real terms since the Staggers Act for all categories of freight traffic, including such supposedly "captive" traffic as coal.

Are shippers always "happy" with the prices they are able to negotiate with the railroads? Of course not. Virtually every purchaser of goods or services (including CSXT) would like to get a better deal than what they have from their suppliers. But if the question is whether railroad prices are market-based and driven by competition, I submit that they are.

As I explain below, with illustrative examples of traffic that we have gained or retained with rate and service concessions to shippers or lost outright to other carriers or modes, the sources of competitive constraints are numerous and their effects are real, substantial and effective.

A. Modal Competition

For virtually all of the freight traffic we handle, including bulk commodities such as coal, grain and chemicals, CSXT faces pervasive competition from trucks, barges and conveyor belts, either alone or in combination with rail movements by one of our railroad competitors. For example, a solely served rail facility can frequently obtain short-haul truck service from a nearby transload facility served by a CSXT rail competitor or by barge. We are constantly pricing our rail services, on new and existing movements, to meet the increasingly competitive inroads by these alternative modes.

Trucks are ubiquitous. They operate everywhere and, by virtue of their mobility and use of the public highway system, are able to reach all of the origination and termination points railroads serve and many that we do not. Motor carriers also enjoy inherent advantages in transit times and service reliability. With changes in truck technology, development of the interstate highway system and increases in the allowed highway weights, trucks have made significant inroads on our traffic, particularly for previously rail-dependent traffic such as coal and other long-haul traffic. Indeed, truck coal provides a good example of the increased competition we face from motor carriers.

Truck transportation of coal has changed radically in the last several years. As recently as ten years ago, coal trucks were limited to 80,000 pounds maximum gross weight. This limited their size to that of a typical "dump truck." Coal trucking was economical only for relatively short distances of 30 to 50 miles.

Today, all that is changing. In many areas of the Appalachian coal fields, trucks operating at 150,000 pounds plus routinely ply their way over the highways, handling half a rail car's load of coal on eighteen wheels. These trucks bear little resemblance to the smaller dump truck which most people think of when they think of trucking bulk commodities. Rather, they are 40 to 50 feet long and closer to the size of a typical tractor-trailer combination.

These changes in truck transportation of coal were made possible in large part by massive highway expansion and improvement programs, primarily in Eastern Kentucky and West Virginia. Main coal hauling arteries were expanded to four lanes and grades were significantly reduced. Secondary, or "feeder" routes were improved into hard surface, all-weather roads. All of this was done at great expense to the federal and state taxpayer.

Barges present a similarly effective and widespread constraint on CSXT's rates and services for solely served rail shippers. Barges are particularly effective in serving bulk commodities (such as coal, grain, chemicals and steel parts) that originate or terminate at points along or near the inland waterways. CSXT's rail service competes directly with coal barged from Appalachian mine origins (often trucked from the mine tippie to a barge loading facility on the river) to power plants in the Southeast and Midwest, and with coal bound for export through the Gulf Coast ports. The same is true for substantial volumes of grain and other traffic.

Motor carriers compete very effectively with CSXT in movements from the coal fields to the Big Sandy, Kanawha, and Ohio Rivers for subsequent barge movement. This "river coal" represents over 20 million tons of business to CSXT every year. Trucking has become a major factor, both for direct rail competition and as an adjunct to rail-rail competition. The total

annual market to the three rivers is approximately 108 million tons. CSXT's share of the total river coal market is relatively small, only about 21 percent.

As a result of this modal competition, CSXT is able to attract and retain freight traffic only by offering shippers competitive rate and service packages. Here are a few examples of particular traffic movements in which CSXT faced direct competition from other modes, often in tandem with competing railroads for a portion of the haul, and in which CSXT was forced to make competitive concessions to attract or retain the traffic or, despite our best efforts, lost out to competing carriers. Many of these examples also illustrate the point I previously made about the importance of rail transportation contracts and the rate and routing freedoms we enjoy under the existing regulatory structure.

- A large chemical manufacturer recently began to switch the previously all-rail (CSXT) shipments of one of its products to barge. CSXT responded with new lower contract rates and retained the business.

- That same chemical manufacturer also switched previously CSXT rail direct shipments of caustic soda to barge/truck and barge/short haul rail. As to these shipments CSXT has either lost the business or been reduced to only a short haul.

- Most paper mills served by CSXT are deliberately sited at locations with direct service from multiple rail, water and motor carriers. As a practical matter, most such plants use all three modes to transport various grades of paper, making this traffic intensely competitive even for those locations where CSXT provides the only direct rail service.

- Several years ago, we were successful in displacing over 1 million tons of coal at Virginia Power's Mt. Storm plant from truck and conveyor belt delivery to all-rail service.

About a year later, the shipper replaced CSXT rail service with truck coal, despite our aggressive efforts to retain this movement through rate concessions.

- Massey Coal used to truck several million tons of coal per year from its Route 3 mining facility to the Kanawha River for transloading into barges. By offering aggressively competitive rates, CSXT was successful in attracting this traffic to a CSXT/barge routing via Huntington area river terminals.

- Peabody Coal built coal conveyor belts between Harris and Kopperston and between Harris and Rocklick, all in West Virginia, to enable it to bypass CSXT rail service. The conveyors move coal to Norfolk Southern loadouts, thus introducing direct rail competition for this origin despite the fact that it was exclusively served by rail by CSXT. The result is a loss to CSXT of more than two million tons of coal per year, which we can win back only by offering competitive rate and service packages.

These examples could be multiplied many times over, but they serve to illustrate the basic point that -- even for heavy-load, long-haul bulk commodities -- modal competition is an effective competitive constraint on CSXT's rates at so-called "captive" shipper facilities.

B. Rail Line "Build-Outs"

Actual and threatened construction of new rail lines by utilities and other high-volume rail shippers is also becoming a more and more frequent competitive factor in CSXT's rate negotiations. Even a casual look at the CSXT system map shows that our rail lines are often located close to those of our rail competitors. This is a direct result of the historic development of rail in the eastern half of the United States.

Recently a major chemical company served only by CSXT threatened to build out to Norfolk Southern or alternatively to construct a pipeline to a nearby connection. In the face of this competition, CSXT entered into a long term rail transportation contract with the shipper on favorable terms for movement of its outbound chemicals traffic.

In late 1995, Alabama Power completed a connection from its Miller Plant near Birmingham, AL to Burlington Northern Santa Fe (BNSF). This plant is now served by BNSF and CSXT.

In early 1997, Savannah Electric, completed a two-mile build-out to NS near Rincon, GA, and is now served by both CSXT and NS.

C. Geographic/Source Competition

Geographic or source competition exerts a significant constraining effect on railroad rates and services for a wide variety of commodities we carry, including traffic at solely served rail locations. A facility exclusively served by rail by CSXT often is able to secure competitive rates as a result of its ability to substitute products from origins not served by CSXT and transported by other carriers. The same is true for solely served origins that can transport their product to alternative destinations. Frequently, this source competition works in tandem with competing railroads or other modes. Let me recite just a few examples:

- CSXT faces competitive price pressures for mineral movements from alternative quarry sites served by other carriers to distribution centers such as Savannah, Georgia. Through the efficiencies afforded by unit train economics, CSXT has been successful in retaining business in selected lanes where this form of competition is present.

- During 1997, CSXT increased its share of coal traffic moving to New England Power's generating facilities, directly displacing imported coal from Venezuela. CSXT's contract service involves rail movements to Baltimore, for transloading to vessel and coastwise movement to the power plant.

- CSXT recently successfully bid on the movement of coal to Detroit Edison's St. Clair power plant, which previously received Powder River Basin coal delivered by western rail carriers in conjunction with a water delivery. CSXT displaced this movement with Appalachian coal handled on an all-rail basis from CSXT-served mine origins.

Another form of source competition occurs in situations in which the customers of our customer have a choice of suppliers. If our transportation rate is a significant element of our customer's product price, failure on our part to properly account for that fact can cause our customer to lose business and hence can adversely affect us as well. An example may be instructive.

CSXT has a raw materials processing customer which is located in Alabama and which ships much of its product via CSXT to manufacturing plants in South Carolina. Recently a competitor of our customer announced plans to build a processing plant in South Carolina, close to the end users of the processed product, the raw materials of which were to be brought in by vessel. By avoiding the rail move, the customer's competitor sought to lower its price and capture the South Carolina market. Had CSXT and its customer not responded, both of us would have lost business. Partnering with our customer, we were able to reduce the delivered price of the product to a level that was acceptable to our customer's customers and was sufficient to retain the business.

D. Product Competition

The ability of a shipper or receiver to substitute different products, transported by the same or a different carrier or carriers, also exerts significant constraints on railroad rates. The most obvious kind of product substitution competition involves shippers who have switched to, or threatened to switch to, alternative fuel sources as a means of exerting leverage over our coal rates. Examples include the following:

- Michigan State University, located at Lansing, Michigan and served by CSXT, can switch its generating plants from coal to natural gas (not transported by CSXT), and does so when delivered gas prices are sufficiently low. CSXT's coal transportation rates must be competitive with this alternative product.

- Several other CSXT-served shippers (Coats and Clark at Albany, Georgia, Griffis Air Force Base at Rome, New York, and several automotive manufacturing plants in the Detroit area) have switched their fuel sources from coal to gas, resulting in a loss of rail business for CSXT.

In order to retain or expand rail traffic volumes for shippers with product options, CSXT must offer competitive rates and service, even though the facilities in question may be served by rail only by CSXT.

E. Multi-Plant Leverage

Many of CSXT's rail shippers, including some of the largest, are able to exert effective leverage over the railroad in negotiating reasonable rates and service as a result of their

ability to shift output among different plants served by different carriers. If CSXT does not or cannot provide competitive rate and service packages to such shippers, they can reduce the output (and thus the traffic they transport via CSXT) at the CSXT-served facility and expand output at other facilities served by different carriers. Shippers with multiple plants frequently threaten us with such traffic losses, and it is a credible threat we take very seriously.

For example, CSXT handles large volumes of traffic for the domestic automobile manufacturers, most of which operate multiple factories located on the lines of different rail carriers. These large and sophisticated shippers use their ability to control traffic volumes at multiple plants to secure competitive rates and services from the railroads.

Utility coal shippers are among the most active exponents of this type of multi-plant leveraging. CSXT serves a large number of electric utilities throughout the Midwest and Southeast regions of the country, and many (if not most) of these utilities own or operate multiple generating plants that are served by different rail carriers, or by trucks and barges, or plants that burn alternative fuels (such as nuclear plants) that do not require rail service.

Many of these utilities frequently tell us in negotiations that if CSXT cannot offer competitive rates to a plant that we exclusively serve by rail, the utility will shift electricity generation to plants served by other carriers, with the result that the utility will reduce coal consumption and coal shipments via CSXT. Indeed, most electric utilities "dispatch" their internal sources of power generation on the basis of relative marginal cost. Because the cost of coal transportation is a major component of a utility's marginal operating expenses, CSXT (and other carriers) must keep their rates competitive in order to maintain and maximize the level of the "burn" at a CSXT-served plant. As a result of these economic "dispatch" factors, CSXT has

made a number of rate concessions to shippers to maintain output (and thus coal traffic volume) at CSXT-served plants.

F. Plant Siting

A final source of competitive leverage that many shippers enjoy is the control over plant siting. With the advent of privately negotiated transportation contracts, shippers are empowered to use their ability to locate their facilities on the lines of different rail carriers or other modes as a means of securing reasonable rate and service terms. This leverage is enjoyed by a wide variety of shippers, but I will mention only two examples.

- Prior to the late 1980's, chicken processing was performed largely in the Midwest, close to the sources of feed stock. During the late 1980's, chicken processors desiring to relocate their operations to the South to take advantage of the more favorable climate and cheaper labor began to work with CSXT to put together rail contract packages that would make economic sense for both sides. This culminated in a series of long term transportation contracts for grain movements into the South to serve newly relocated poultry processing plants. The freedom we enjoyed to negotiate private contracts without regulatory interference were a primary factor in this major shift.

- Steel mini-mills are a fairly recent phenomenon that, over the last several years, have come to capture nearly half of the steel production market. Most (if not all) of these mini-mills are "green field" operations, and thus are very careful about siting decisions. As a routine matter, firms developing such facilities seek -- as a condition to locating on a particular railroad's lines -- competitive service from two independent railroads (through trackage rights,

switching or similar arrangements), and often locate near highways and/or waterways in order to maximize their competitive transportation options. Examples include: (1) Gallatin Steel at Carrollton, Kentucky (served by CSXT, but with haulage on behalf of Conrail over Cincinnati and Norfolk Southern over Louisville, and also served by water); (2) Nucor at Berkley, South Carolina (served by CSXT, but with haulage on behalf of Norfolk Southern); (3) Trico at Decatur, Alabama (served by Norfolk Southern, but with haulage on behalf of CSXT); and (4) Steel Dynamics at Butler, Indiana (served by Norfolk Southern, but with a reciprocal switch arrangement in favor of CSXT). These joint service arrangements were brought about through competitively-induced (not government mandated) circumstances and have been made workable by negotiation among the parties involved.

* * *

The point of the preceding discussion has been to show that railroads (including CSXT) face effective competition from a variety of sources for virtually all of the freight traffic they carry. Even so-called "captive" shippers, who are served by only one rail carrier, enjoy various forms of effective competitive leverage in negotiating reasonable rates and service. I would not for a moment pretend that there are no shippers that lack effective competitive alternatives. For that reason, the existing regulatory system, which has served the rail industry and shipping public so well, provides a remedy for shippers who face excessive rail rates as a result of a lack of effective competitive alternatives -- a remedy that, I understand, a small handful of primarily coal shippers have invoked successfully in recent years. But the need for such a remedy is very limited, as evidenced by the fact that few maximum rate complaints have even been

filed with the Board and the ICC. The vast preponderance of rail freight traffic is unquestionably subject to intense and effective competition.

III. Railroad Mergers and Consolidations Have Increased Competition and Benefited Shippers.

Various shipper interests which have proposed radical re-regulation of the rail industry frequently argue that recent railroad mergers and consolidations, by reducing the number of major rail carriers, have extinguished genuine rail competition. And it is claimed that the imposition of intrusive new forms of regulation -- including "bottleneck" rate regulations and mandated trackage rights and other forms of forced access to solely served facilities -- is somehow necessary to restore the competition that has been lost as a result of these transactions. This argument has become so prevalent among shipper representatives with whom I deal that it can fairly be characterized as the basic mantra of the advocates of re-regulation.

This kind of argument may make for easily digestible sound bites, but it is fundamentally flawed. Consolidation of the Nation's railroads and rationalization of the network have been going on more or less continuously since at least World War I. The pace of railroad mergers and consolidations during the post-Staggers era is simply the logical outgrowth of this process. Most of the recent large rail consolidations -- including our proposed joint acquisition with Norfolk Southern of Conrail -- have involved largely end-to-end transactions, with little (if any) reductions in the number of railroads that directly serve particular shippers. And, when these transactions have involved consolidation of parallel lines and loss of direct rail competition at points previously served by multiple rail carriers, the Board and its predecessor have taken great

care to impose conditions (often proposed, as in the UP/SP and proposed Conrail transactions, by the applicant carriers themselves) to preserve pre-existing competition, such as through the grant of trackage rights to another carrier. In the Santa Fe/Southern Pacific case, the ICC actually denied the proposed consolidation outright because of adverse effects on direct rail competition between the two applicant carriers. In no recent rail merger transaction approved by the agency has there been any significant loss of direct rail competition.

The more important point, however, is that recent rail consolidation transactions have been strongly pro-competitive, and nothing less than a boon for shippers. These transactions (including the Chessie/Seaboard merger that created the CSXT system) have enabled railroads to become more efficient, improve service, reduce costs and compete more effectively with other railroads and, importantly, with other transportation modes. In a very real sense, rationalization of the Nation's rail network through recent rail consolidation transactions has enabled the industry to take full advantage of the ratemaking and routing freedoms of the post-Staggers period. As I have previously stated in other forums, de-regulation and consolidation have been the twin engines powering the industry's growth by allowing us to offer shippers better economics to earn more of their shipment volume.

Recent rail consolidations (including the proposed Conrail transaction) benefit shippers in many ways. Perhaps foremost among them is the creation of expanded single-line rail service. End-to-end consolidations of the kind we have witnessed in the rail industry over the past two decades have increased opportunities for longer single-line hauls, thereby eliminating costly and time-consuming interchanges between independent carriers. Single-line service enjoys a number of well known advantages over interline service, including:

- Reduced Transit Times
- Increased Reliability of On-Time Delivery
- Improved Safety and Reduction in Loss and Damage
- Improved Equipment Utilization

The rail consolidations that have created the existing rail systems (including CSXT) also made possible the practice of consolidating traffic on high-density routes, thereby achieving lower unit costs and justifying substantial infrastructure investment in high-capacity lines. This has enabled the railroads to eliminate redundant or unnecessary lines, classification yards and other costly facilities, or to transfer them to short-line operators better able to operate such low-margin assets profitably. The bottom line is that CSXT (like other railroads that have been involved in consolidation transactions) has succeeded in substantially reducing its costs of service and rate levels for shippers while at the same time increasing capital investment and improving its overall financial results. Railroad consolidations have played an enormous role in making these service improvements and rate reductions possible.

IV. The Rail Industry Critically Needs Adequate Sources of Capital For Investment in Existing and Expanded Capacity.

The final point I want to make is in the nature of a plea. As the Board is aware, railroading is an extremely capital intensive industry. In reliance on the de-regulatory reforms of Staggers, and the promise that railroads will be allowed (if market conditions permit) to earn adequate revenues generating a competitive cost of capital rate of return, CSXT and other railroads have succeeded in attracting the capital necessary to make extraordinary increases in

investment in needed plant and equipment. (Mr. Ward describes those investments in his separate statement.) Although we have made great strides toward the goal of revenue adequacy, CSXT still is not earning its cost of capital as measured by the Board.

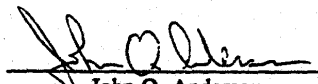
We have been able to attract the necessary capital to invest in maintenance and modernization of our rail infrastructure only because investors believe we are moving in the right direction. I am deeply concerned that, if Congress or the Board were to impose new and onerous regulatory burdens of the kind some shippers have proposed (the sole objective and unavoidable effect of which is to reduce railroad rates and revenues), our ability to attract capital will be eroded, with devastating consequences for the industry and, ultimately, the shipping public.

If we are not allowed to generate the competitive returns necessary to attract additional capital, railroads will not be the only losers. The entire U.S. economy will pay the price. As the recent service disruptions on the UP/SP system alarmingly suggest, capacity and infrastructure limitations on even a small portion of the rail network can have massive adverse repercussions rippling throughout the economy. Increasingly, the rail freight network is the artery of domestic commerce, including the production of goods that we sell overseas. And capital investment is the lifeblood of the rail industry. We will need more, not less, investment in this industry if we are to meet the shipping public's demands for safe, efficient and reliable transportation service. Re-regulation of the railroads will not allow this to happen, and for that reason is not the way to go.

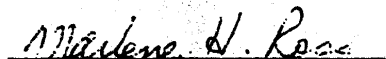
VERIFICATION

COUNTY OF DUVAL)
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STATE OF FLORIDA)

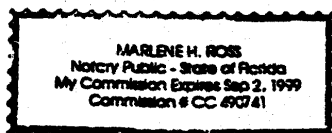
JOHN Q. ANDERSON, being duly sworn, deposes and states that he has read the foregoing statement, knows the contents thereof, and that the same are true and correct to the best of his knowledge, information and belief.


John Q. Anderson

Subscribed and Sworn to Before Me
This 20th Day of March, 1998.


Notary Public

My Commission expires:



WARD

**BEFORE THE
SURFACE TRANSPORTATION BOARD**

STB Ex Parte No. 575

REVIEW OF RAIL ACCESS AND COMPETITION ISSUES

VERIFIED STATEMENT

OF

MICHAEL J. WARD

My name is Michael J. Ward. I am Executive Vice President Finance for CSX Transportation, Inc. (CSXT). In this position, I am responsible for the railroad's accounting, budgeting, cash management, auditing and capital budgeting; as well as financial reporting, planning and analysis. During my 20-year career with CSXT and its predecessor companies, I have held numerous positions in Finance, Operations and Marketing, including Vice President Coal Marketing and General Manager - C&O Business Unit.

In this verified statement, I will discuss the financial performance of CSXT and its predecessor lines under the post-Staggers Act regulatory regime and the immense capital investment the company has been able to make in rail facilities and equipment as a result of our improved financial performance. Since 1981, CSXT has invested over \$8.9 billion in capital improvements (not including repair and maintenance expense) to right-of-way (\$5.7 billion) and rolling stock (\$3.2 billion), even as its revenue per ton-mile has dropped by 50 percent on an inflation-adjusted basis. This high level of investment has been made possible by the financial

investment is expected to shrink the network's total operating time by over 110,000 train-hours per year, reducing line-of-road congestion and improving service reliability.

We intend to increase total track and structures expenditures to \$464 million in 1998 – up from \$390 million in 1997.

CONCLUSION

The de-regulatory freedoms of the Staggers Act, as implemented by the Interstate Commerce Commission and now the Surface Transportation Board have unquestionably been a success. CSXT's financial performance in the era of de-regulation has been part of that success story. We have poured billions of dollars back into our system to the benefit of our customers while freight rates have fallen.

Our plans for the future depend on continued strong financial performance. There is no justification to re-regulate the industry.

Routing flexibility was also an important part of the Staggers Act regulatory freedom. As CSXT emphasized single-line service in preference to inefficient and often circuitous multi-carrier routes, we were able to route traffic more efficiently. We consolidated traffic, thus increasing density and reducing costs, while at the same time delivering better service to our customers.

Finally, with the stimulus of rate freedoms, our efforts to reduce costs, and the knowledge that regulation would not punish us for increasing efficiencies, we were able to increase our capital expenditures. Today, we see a true renaissance in the rail industry as more traffic is returning to the rail system.

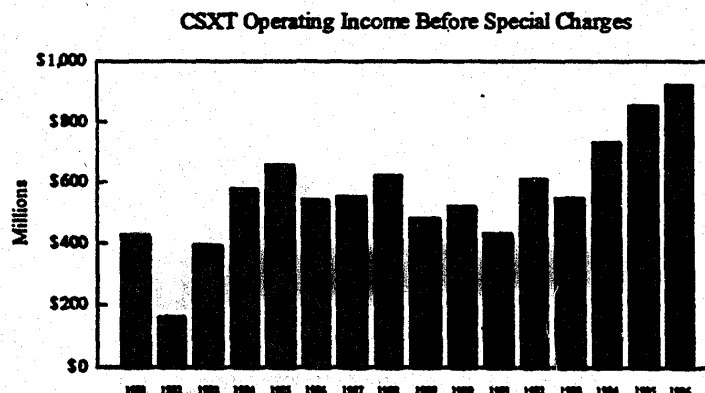
CSXT's Financial Performance Since the Staggers Act

CSXT's financial performance speaks for itself. Almost every financial indicator has trended in a positive direction.

The only key indicator that has trended negatively for CSXT since the Staggers Act is price. CSXT freight revenue per revenue ton-mile on an inflation-adjusted basis has fallen 50 percent since 1981. This is a direct consequence of deregulation. The freedom to compete brought the discipline of the marketplace, and that discipline is reflected in the downward trend in CSXT's prices. The marked decline in price levels demonstrates that CSXT is in intense competition with other railroads and with other modes of transportation.

Our most competitive traffic, even at reduced prices, has benefited both CSXT and other shippers - including those who characterize themselves as "captive". This traffic covers the incremental cost of providing the service and makes a contribution to the total fixed cost of the network, including maintenance and capital investment.

Although CSXT is not yet earning its cost of capital on a long-run (or even a short-run) basis – even on historic costs – it has, nonetheless, made marked improvements in operating income.¹ Operating income has grown steadily since the early 1980s.

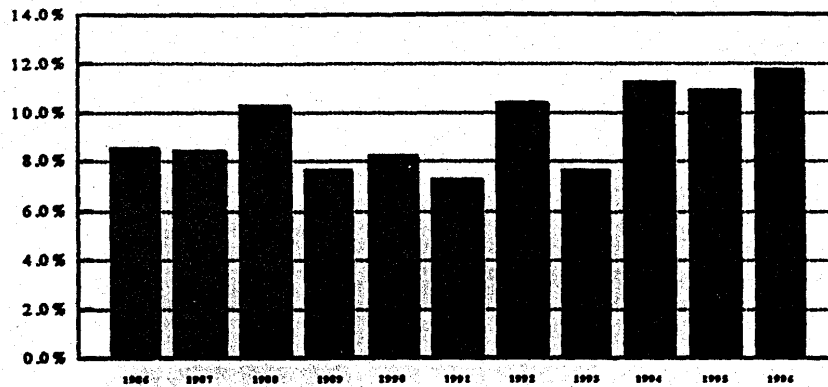


CSXT's ten-year average return on equity (without special charges) has been 9.4 percent.²

¹ Over the long term, if CSXT is to remain a viable company, it must earn a return on investment at least equal to its cost of capital on a replacement basis.

² In 1988, 1991 and 1992, large special charges were taken when CSXT negotiated long-term cost savings arrangements with key labor unions. With those special charges, CSXT's ten-year average return on equity was only 5.9 percent. Those special charges reflect actual cash outlays and should certainly be included in considering the profitability of the business. In any case, neither figure suggests that CSXT is earning monopoly profits.

**Return on Equity
Excluding Special Charges**



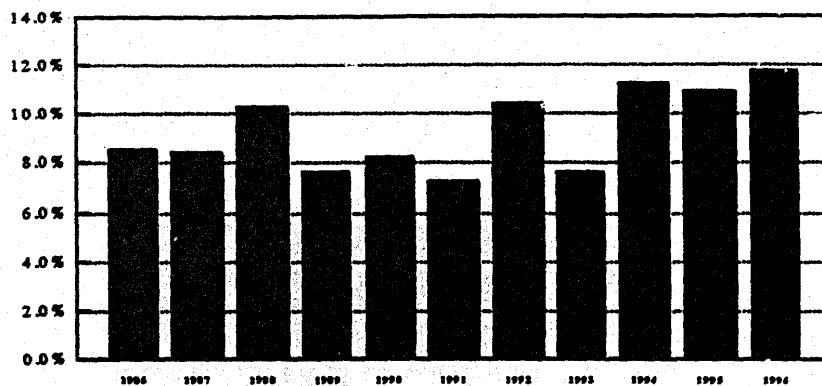
One of the key measures of financial performance in the transportation industry is operating ratio. CSXT has reduced its operating ratio from 91.3 percent in 1981 to 81.1 percent in 1996.³

³ Here, as in numerous places throughout this verified statement, I use CSXT's R-1 report data for the Board's convenience in comparing to other railroads. The most recent R-1 data is for the year ended December 31, 1996.

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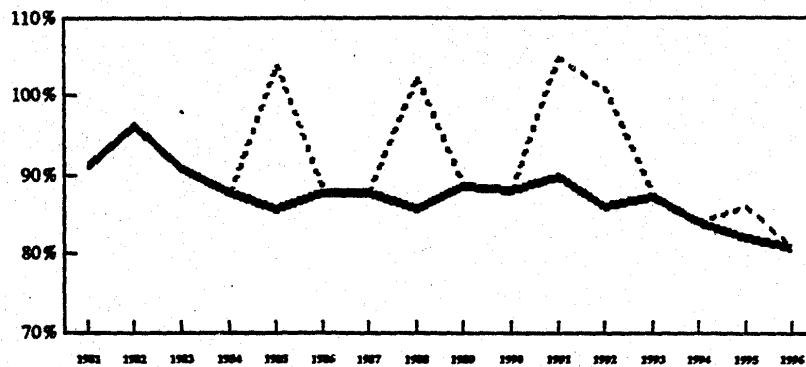
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Operating Ratios

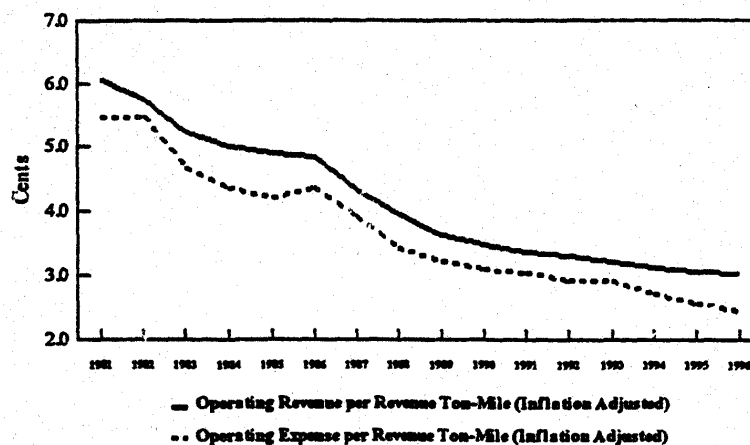


-- Operating Ratio (Including Special Charge) == Operating Ratio (Excluding Special Charge)

We will continue our concentrated focus on all the factors that affect the operating ratio with the goal of driving it lower still.

The following chart demonstrates very effectively the bottom line for CSXT and its shippers since the Staggers Act. CSXT's prices have fallen since deregulation – almost in parallel with the cost reductions we have made.

Revenue and Expense per RTM
(In 1996 Dollars)



As we have squeezed the inefficiencies out of the system, we have passed the savings on to our customers. In doing that, we have been able to attract new traffic to the railroad, much of it through improvements in service in addition to lower prices.

Capital Investment and Maintenance

CSXT's ability to differentially price has increased our traffic base. Some of this traffic (e.g., intermodal) has been lower margin business, but it contributes to the fixed cost of running our railroad network. All of it has contributed to improved earnings.

CSXT has reinvested its increased earnings back into rail plant and facilities. Our capital investment, while it has fluctuated from year to year, has trended upward. Railroading is a capital intensive industry. Since 1981 CSXT has invested a total of \$5.7 billion in its fixed physical plant, i.e., right of way and structures. Maintenance expenses over the same period exceeded \$8.3 billion.

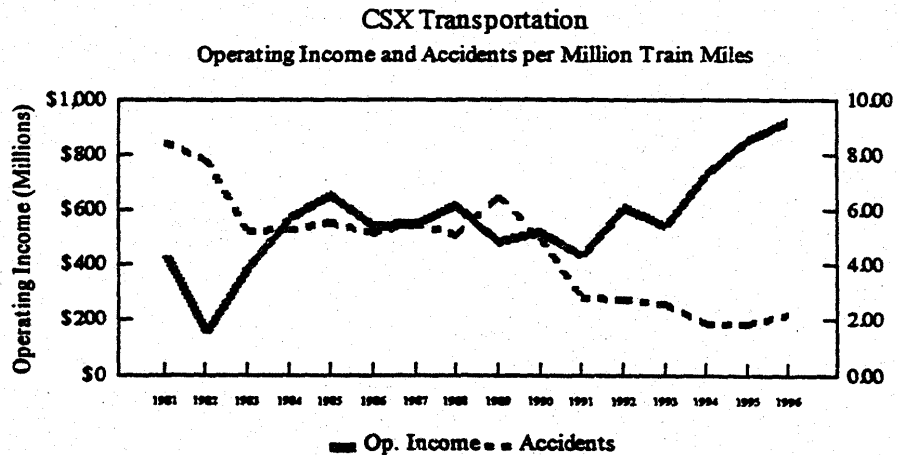
Total Capital and Maintenance
of Way and Structures Expense
1981 through 1996

Track (capital)	\$ 5.7 Billion
Track (expense)	\$ 8.3 Billion
Total way and structures	\$ 14.0 Billion

As I explain with examples later, our income from rail operations has been used to improve our railroad, to the benefit of rail shippers.

System-wide improvement in rail safety

Our capital expenditures and an aggressive no-excuses attitude toward safety have helped CSXT make quantum strides in improving the safety of its operations and its employees. Investing heavily in track and equipment maintenance has helped us bring down train accidents from 8.67 per million train miles in 1981 to 2.25 per million train miles in 1996. We still need to make further improvement, but we are proud of what we have accomplished thus far.



Loss and Damage

Our customers have seen the benefit of our improvements in the network and in our operations. For example, we are handling more freight with less damage than ever before. Loss and damage as a ratio per \$100 of freight revenue is down from 34 cents in 1986 to 19 cents in 1997, for a cumulative percentage reduction of 44.1%.

Shippers are no longer willing to accept that a certain amount of damage occurs when they ship by rail. By driving down damage to our customers' goods through investing money back into our infrastructure, we have encouraged many of those who are most service sensitive to come back to the rails from truck.

Representative Capital Projects

Our ability to fund major capital improvements has made a material difference in the quality of our railroad's physical plant. Generally speaking, CSXT funds investment in track structure and repairs to cars and locomotives from earnings. In our efforts to reduce our debt to equity ratio, we have tended not to borrow more than is truly necessary. This means that we have substantial, but still limited, capital budgets. Nonetheless, in addition to keeping up our network, CSXT has been able to engage in numerous major capital programs. Here are just a few examples:

The J. T. Collinson bridge over Escambia Bay

This two-mile long bridge spans the Escambia Bay at Pensacola, FL. The concrete and steel bridge is a key part of CSXT's route from Jacksonville to New Orleans – a major East-West gateway – and was built at a cost of \$24 million in 1986-7.

Ohio River subdivision upgrade

In 1994-5 CSXT performed a complete rehabilitation of this subdivision including rail, ties, and roadbed stabilization to accommodate increased tonnage at a cost of \$25 million.

Locomotives

From 1989 to 1998, including units now under contract, CSXT's purchase of new locomotives will total 845 units, at a total cost of \$1.2 billion. CSXT has a multi-year contract with General Electric to acquire \$500 million worth of locomotives, including the first 6,000 horsepower units to enter service in this country. These upgraded units will enhance train performance, replace retiring older units which are more susceptible to breakdown, and give CSXT's operations personnel more flexibility.

Automatic Equipment Identification

CSXT's investment in this nationwide program to equip every freight car and locomotive with electronic transponders to enable remote identification of units together with the cost of automatic tag readers and connections to our mainframe computer, totaled \$24 million from 1992-5. In addition to many other advantages, this technology enables us to provide more reliable shipment tracking information to our customers.

Atlanta, northward

In 1996, CSXT spent \$6.5 million to double track nine miles of line on the main line north of Atlanta to increase capacity over this key North-South route.

Dispatching Center

From 1988-90, we invested over \$29 million to consolidate all train dispatching operations in a state-of-the-art Operations Center at Jacksonville, FL.

Data Systems Technology

CSXT is at the early stages of a multi-year effort to totally re-engineer all of our customer service data systems. This effort will replace current mainframe and DOS-based systems with Windows-based software that will completely revamp customer car ordering, bill of lading transmission, plant switching directions, car tracing, price retrieval, etc. At first, many of these functions will be performed only by our customer service representatives at our customer service center in Jacksonville. Ultimately, customers will be able to access these services via the Internet. Our current systems require fairly extensive familiarity with alpha-numeric codes to operate. These new systems will incorporate plain English instructions and "icons" in a graphical user

interface and will be much more user-friendly. The total budget for this project, including Internet access, is over \$26 million.

Communications

The ability to communicate with train crews is critical if we are to achieve our ambitious service goals. Between 1988 and 1990, we spent \$9 million to replace radio base stations and locomotive radios so that they would be compatible with the new Dispatch Center. From 1988 to 1994, we spent \$12 million on defect detectors to reduce the spacing of these warning devices to between 20 and 25 miles.

Ongoing replenishment of basic capital assets

Since 1980, CSXT has laid 47 million crossties and 24,000 miles of rail. Since 1980, CSXT has acquired 8,198 new auto racks to serve the auto industry at a cost of over a quarter of a billion dollars. Since 1989, an aggressive coal hopper program has enabled us to purchase or rebuild over 16,000 coal cars. In the last two years we have invested \$30 million in freight cars to haul minerals.

Our willingness and ability to make these capital investments have been based upon our expectation that the market place would continue to allow us to compete. We have relied on the rate and route freedoms granted to us under the Staggers Act, including the critical, and successful, differential pricing policies endorsed by Congress, the ICC and the courts. We are optimistic that if we are permitted to continue to implement these freedoms we can move CSXT to even higher levels of performance. Continued strong earnings with the ability to reinvest in the network and to obtain capital is critical to this process. Re-regulation seriously threatens that promise.

Capital Investments Associated with Conrail Control Transition

CSXT will make over \$500 million in capital expenditures to take maximum advantage of the commercial opportunities of the Conrail control transaction, if the pending application is approved by the Board. These expenditures will be over and above CSXT's regular capital program.

Much of this investment is designed to position CSXT's intermodal service to compete effectively with motor carriers in critical east-west traffic lanes and particularly in the New York to Chicago lane. For example, CSXT will construct a new intermodal facility at 59th Street in Chicago at a cost of over \$25 million. Additional capital will be used to expand Conrail's Collinwood Yard in Cleveland into a state-of-the-art intermodal hub. Another new intermodal facility is planned for Greenwich Yard in Philadelphia, and intermodal facilities at Forest Park (Chicago), Bedford Park (Chicago) and Little Ferry (NY/NJ) will be upgraded.

To provide our customers with the high speed east-west route that we will need to compete with trucks and to remain competitive with Norfolk Southern, CSXT will spend over \$245 million to upgrade its route between Cleveland and Chicago, including double tracking the former B&O main line from Greenwich, Ohio to Chicago and expanding and upgrading the Willard, Ohio yard. We will make maximum use of the new routes available by constructing new connections between CSXT's present lines and the lines of Conrail which we will operate.

By increasing the overhead clearance of the Virginia Avenue tunnel in Washington at a cost of \$ 19 million, CSXT will open a service route for multilevel traffic that will create a new rail lane for motor vehicle manufacturers parallel to I-95 for the length of the entire East Coast.

These investments are driven by market forces. They are essential if CSXT is to compete effectively with Norfolk Southern and the motor carriers that dominate the inter-city freight transportation market in the East.

Other Future Investment

CSXT's other investment plans for the future are designed to enable us to make major gains in service reliability. Nearly 8,000 miles of the CSXT system uses wooden poles (much like telephone poles) to support the dispatcher code line, DC vital circuits and AC electrical circuits. These, respectively, control switches; monitor the presence of trains; and provide power to grade crossing, signal and switch locations. In 1995, CSXT began an investment program that dedicated \$260 million over seven years to eliminating 7,000 miles of the poleline system. We will replace dispatcher code line with radio code, replace DC poleline vital circuits with AC electronic track circuits and replace AC electrical poleline with individually metered AC services at selected locations.

The old pole line system is woefully vulnerable to falling tree limbs in storms. A single break in a wire can bring a main line to a near halt as all operations shift from efficient, remotely controlled automatic block signal operation to "dark territory". We believe this new technology will eliminate a large percentage of signal failures per year.

Along with this \$260 million investment, CSXT is also investing \$40 million over the next four years to convert manual, locally-controlled interlockings into electronically-operated interlockings, controlled from the dispatching center in Jacksonville. This \$300 million

investment is expected to shrink the network's total operating time by over 110,000 train-hours per year, reducing line-of-road congestion and improving service reliability.

We intend to increase total track and structures expenditures to \$464 million in 1998 -- up from \$390 million in 1997.

CONCLUSION

The de-regulatory freedoms of the Staggers Act, as implemented by the Interstate Commerce Commission and now the Surface Transportation Board have unquestionably been a success. CSXT's financial performance in the era of de-regulation has been part of that success story. We have poured billions of dollars back into our system to the benefit of our customers while freight rates have fallen.

Our plans for the future depend on continued strong financial performance. There is no justification to re-regulate the industry.

VERIFICATION

STATE OF FLORIDA)
)
COUNTY OF DUVAL) SS:

Michael J. Ward, being duly sworn, deposes and says that he has read the foregoing Statement, knows the contents thereof, and the same are true to the best of his knowledge, information and belief.

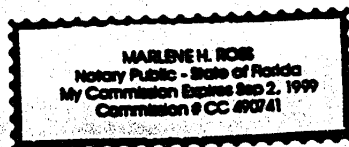
Michael J. Ward
Michael J. Ward

STATE OF FLORIDA
COUNTY OF DUVAL

The foregoing instrument was acknowledged before me this 24th day of MARCH, 1998, by Michael J. Ward, who is personally known to me and who did take an oath.

Marlene H. Ross

Notary Public
Commission Expires:



McClellan

Verified Statement

of

James W. McClellan

My name is James W. McClellan. My position with Norfolk Southern Corporation (NS) is Vice President - Strategic Planning. I have overall responsibility within NS for strategic and corporate planning, mergers and acquisitions, and management of the size and scope of NS's route network.

Qualifications

I began my railroad career in the Marketing Department of Southern Railway Company in 1962, and subsequently worked for the New York Central (and its successor, Penn Central) in domestic and international marketing. I served with the Federal Railroad Administration in policy and planning positions from late 1968 to mid-1971, when I joined Amtrak in a senior marketing position. I returned to the Federal Railroad Administration in late 1973; the focus of my job was the growing eastern railroad crisis. In late 1974 I joined the newly created U.S. Railway Association where I was responsible for the planning of much of the eastern rail network. I moved to the Association of American Railroads in 1976. In 1977 I returned to Southern Railway as Director - Corporate Development. I was promoted to Assistant Vice President - Corporate Development in 1991 and to my present position in 1993.

Of particular relevance to this testimony is my broad responsibility for defining NS's route system. My duties encompass not just mergers and acquisitions but purchases, abandonments and sales/leases of line segments, joint usage with other carriers and formulation of policies toward, and negotiations with, passenger entities.

I am especially familiar with facility-sharing in the railway industry. NS shares facilities with most major railroads, with a number of regional and shortline railroads and with Amtrak and two commuter agencies (METRA and Virginia Railway Express).

illness -- too many employees, too many passenger trains -- has been corrected in the U.S. I would conclude that applying an experimental remedy to a patient who has already recovered, just because European governments think the remedy might benefit their patients, is not sound policy.

Conclusion

The railroad industry faces enormous challenges in the years to come: attracting capital for capacity improvements; increasing revenues; and achieving the kind of service we have long promised but in the past often failed to deliver. But there have been accomplishments, particularly when viewed from the perspective of twenty years ago when I was in government. If we are to build on these accomplishments, we must not discard the policies that made them possible.

for a road system. And almost from their beginning, railroads began to develop into networks.

As early as 1850, a student of the industry wrote:

A railway [is] like a vast machine, the wheels of which are all connected with each other and whose movement requires a certain harmony. [It] cannot be worked by a number of independent agents. Hence, it followed, as a necessary consequence . . . that the companies originally established for the construction of a road only became in spite of themselves, the exclusive carriers on it.¹

Even today, most rail systems in the world remain vertically integrated and almost all are network businesses. (Less developed countries, certain specialized heavy-haul and high-speed passenger services are the exception.) Thus the original organizational model has endured for over a century and a half in a variety of economic, political and cultural systems. There may be a message here. It is my conviction that railroads are organized the way they are for fundamental economic and operating reasons.

The Technological and Managerial Basis for Organization

Most importantly, the efficient vehicle for rail operations is the train, not the railcar. With few exceptions, available traffic is scattered between a multitude of origins and destinations few of which ever generate a trainload of traffic over any reasonable time frame. Someone must organize this traffic into trains to be moved to the next hub, where it is once again sorted into trains. Traffic flows vary by day of the week and week of the year, so there is a constant tension between the need to move individual shipments when offered and the economic need to accumulate traffic into efficient "production units."

At the same time, because of its high costs infrastructure must be used efficiently. Too much infrastructure wastes capital and maintenance budgets; too little causes delays and higher

¹ Dionysius Lardner, Railway Economy: A Treatise on the New Art of Transport (New York: Harper, 1850), pp. 421-22.

costs for operations and vehicles. A more robust infrastructure would allow higher speeds and/or heavier loads, but it would cost a lot of money.

The proper balance of these factors -- investment, maintenance and operations -- is best achieved through a centralized control structure, where the complicated tradeoffs can be made. Operational decisions involving the number of trains to be run have to be made on a daily and often hourly basis. Fragmented or committee decision-making is simply inefficient. A "command and control" management structure exists because it has proven over time to be the most effective.

Customer-Customer and Customer-Carrier Conflicts

Railroads, because of their technology, are not an egalitarian system. Customers must adjust their individual needs to the needs of the overall system. I, as a passenger, may want to leave at 5:05. But some distant decision-maker has decided that to accommodate other customers or for reasons of system efficiency the train will depart at 5:30. Likewise, some other decision-maker must balance the desires of each customer to pay the lowest possible rate with the requirement that the overall network take in enough money to pay for all the things needed to keep the network functioning now and into the future.

Many of the conflicts among customers and between customers and carriers (and especially between smaller customers and carriers) can be traced to the simple fact that railroads run trains. Different customers have to share the same train (unless they have an awful lot to ship at one time) and different customers have to share the same right of way. And someone has to decide who shares which train; when the train is going to run; and who is going to share the track and when. And then someone has to collect money from the customers and pay all the bills. It is neither a simple system, nor given the economics of railroading, a "fair" system, if "fairness" means treating everyone equally.

Forced Access Proposals Are Inconsistent with Network Fundamentals

Forced access proposals try to make the system "fairer" by shifting control of the network from carriers to certain users. Some proposals would allow users to override a carrier's routing

initiatives and dictate how particular movements flow. The problem is, not only would this diminish the network benefits available for all, it would reduce, through user attrition, the quantity of traffic contributing to fixed costs. The result would be a double whammy: the network would become less valuable and more expensive.

The network would become less valuable because traffic moving out of major flows generally takes longer and requires additional handlings. "Out of flow" interchanges cause operational problems and fragmented traffic, and when flows are fragmented, service reliability suffers for all. That is why rail carriers have used the Staggers Act's deregulatory framework to concentrate major flows on heavily used main lines, allowing the frequent service necessary to keep the network attractive to competitive users.

At the same time, the network would become more expensive, because as service quality declined competitive traffic would migrate to other transportation modes, raising the contribution to fixed costs required of remaining users. Network benefits cut both ways. When users begin to desert a network, its value to those remaining and attractiveness to prospective users can deteriorate rapidly.

"Disassembling" the Network

When railroads were young, the only way to escape the "unfairness" of the system was to use a horse (which was slow) or find a sympathetic regulator. That all changed with the advent of motorized highway transportation, and in the decades that followed more and more customers escaped from the command and control regime of the railway to one of personal freedom. They got a car or they got a truck and they departed the railway network. Everyone was then free to depart, though some did not because the alternatives were too slow (for example, commuting in a large urban city) or too expensive.

By the 1960s and 1970s enough customers had departed that all of the rail passenger network and significant parts of the rail freight network were at or near financial and/or physical collapse. Government response (and I was privy to much of the internal decision-making) ultimately dealt with the problem by partially "disassembling" the system. Intercity passenger

services could have been handled by outright abandonment or by simply subsidizing railroad operators directly. That would have been easier than creating a whole new management structure, and DOT considered it. But the political reality at the time would not permit such an approach.

Likewise, much of the rail freight system had such light density that it might not survive at all, but certainly could not survive with the cost structure of a trunk line railroad. The direct approach would have been to negotiate lower labor rates with the unions and contract out maintenance functions to lower cost operators. That was not politically feasible either, so the trackage was spun off to new operators.

Because the rail system's disassembly was largely a response to political considerations, rather than economic or operating criteria, it is not surprising that it created a number of costly interface problems. Take the Amtrak-freight railroad relationship. Amtrak uses the freight lines as an incremental user. That works fine so long as the line used has adequate capacity and will be maintained to passenger standards anyway. But as some lines have been downgraded and other lines grow more congested, Amtrak is an increasingly unattractive tenant. Conversely, where Amtrak owns the track, it tailors investments and operations to its own business. Conrail not only pays extraordinary fees for using the Northeast Corridor, it is limited as to when it can run trains and as to the loading weight of its cars.

This is not to say that system disassembly is always inappropriate. When NS and CSX made their plan for Conrail, it was clear that certain terminal segments had to be operated for the benefit of both carriers lest the overall eastern rail system become dominated by one railroad or another. There was also the fact that Conrail had rationalized the terminal segments in a manner that made it difficult to partition them. The solution was to draw lines around the terminal segments and reconstitute them as shared asset areas.

But where there are no clear economic incentives, disassembly cannot endure, at least not without strong legal enforcement. Part of the current dilemma in the Amtrak-freight railroad relationship is that the benefits for freight railroads accrued almost thirty years ago. Without

positing continuing economic benefits, proponents of forced access essentially are positing a win-lose situation.

The "Separate Right-of-Way" Model

Notwithstanding the above difficulties, some now argue for wholesale disassembly of the network. There is considerable intellectual interest in separating the fixed plant from the operating entity. Such a framework would mimic the current structures for the highway and airway systems. It might feature "open access" whereby all who met safety standards would be allowed to use the railroad, or it might be a "closed" system that would limit use to one, or only a few operators.

The U.S. Railway Association looked at splitting the fixed plant (into something that we called "Confac" for Consolidated Facility Corporation) from operations. Public funding for infrastructure could then be focused on a publicly owned entity. But closer examination led us to conclude that separation of infrastructure investment decisions from operating decisions was a mistake.

The primary challenge to core rail freight service providers worldwide is to handle freight rapidly, on-time and at the lowest possible cost. As just one example of how difficult this becomes when railroad functions are disassembled, consider the most basic element of rail infrastructure, track. Track is a critical part of the railroad "factory." To achieve the lowest cost and highest quality service, it must mesh perfectly with the other parts of the factory. Thus railroads carefully target track standards, capacity and maintenance levels to the specific needs of customers on a line. If standards are too high or there is too much surplus capacity, those extra costs are going to impact the bottom line. Achieving the right balance in just this one area of the "rail transportation production process" is hard enough when everyone is on the same team. When those responsible for track standards and maintenance do not also provide transportation service to the customers on the line, it is practically impossible.

In addition, when infrastructure and operations are disassembled, there still has to be a command and control system deciding on safety rules, dispatching the trains and making

investments in new capacity. Inevitably, that command and control system (an "FAA" of the railroads) is going to have to make the same sort of difficult tradeoffs that railway managers make today. And there is no reason to believe that they will be any better able to sort out all of the conflicting needs, much less make any more informed judgments about the fees required for usage. There is certainly no reason, based on both highway and airways models, to expect that adequate investments in capacity, or even adequate maintenance, will result.

European Experiments with Restructuring

Until recently, most European systems shared these common characteristics: public ownership, vertical integration, focus on passenger service and huge losses. Most have experienced a loss of market share, with losses of freight share especially severe. It can be fairly said that European railroads are increasingly irrelevant to the freight transport system.

Faced with mounting deficits, an entrenched railroad bureaucracy and a bloated union work force, governments have attempted to stir some life into the equation by changing the structure of the business. Great Britain has gone the furthest; the track structure is owned by one entity (still heavily dependent on government subsidies) and the operations have been franchised to a number of "private sector" companies. Virtually all have received subsidies and all enjoy a monopoly on the services they provide (for example, intercity passenger services on the West Coast Route or commuter services on the Southeastern Network).

Throughout the rest of Europe there have been various plans for change, and some tentative first steps have been taken in countries such as Sweden. But meaningful change will run hard up against the reality that the railroads do not want to change, the labor unions refuse to change and no one wants to lose services. One thing is clear. The infrastructure company in Britain and the operating companies are engaged in a lot of discussion about how much capacity and maintenance is required and who is going to pay. The fundamental allocation of resources issues that were internal to British Railways have simply been externalized.

European restructurings are aimed at making rail systems more efficient. Whatever else might be said about the U.S. railway system, it has been made more efficient. The European

illness -- too many employees, too many passenger trains -- has been corrected in the U.S. I would conclude that applying an experimental remedy to a patient who has already recovered, just because European governments think the remedy might benefit their patients, is not sound policy.

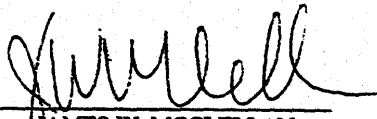
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The railroad industry faces enormous challenges in the years to come: attracting capital for capacity improvements; increasing revenues; and achieving the kind of service we have long promised but in the past often failed to deliver. But there have been accomplishments, particularly when viewed from the perspective of twenty years ago when I was in government. If we are to build on these accomplishments, we must not discard the policies that made them possible.

VERIFICATION

COMMONWEALTH OF VIRGINIA)
) SS:
CITY OF NORFOLK)

JAMES W. MCCLELLAN being duly sworn, deposes and states that he has read the
foregoing Verified Statement, knows the facts asserted therein and that the same are true
as stated.



JAMES W. MCCLELLAN

Subscribed and sworn to before me,
a Notary Public in and for the
State and City aforesaid, this
23 day of March, 1998.



NOTARY PUBLIC

My commission expires:

MARCH 31, 1998

[SEAL]

KALT/REISHUS

**BEFORE THE
SURFACE TRANSPORTATION BOARD**

**STB EX PARTE NO. 575
REVIEW OF RAIL ACCESS AND COMPETITION ISSUES**

**JOINT VERIFIED STATEMENT
OF
JOSEPH P. KALT AND DAVID REISHUS**

I. INTRODUCTION

LA Witnesses Qualifications and Background

Joseph P. Kalt is the Ford Foundation Professor of International Political Economy and Chairman of the Economics and Quantitative Methods Section at the John F. Kennedy School of Government, Harvard University. He has also been the Academic Dean for Research, Faculty Chair of the Kennedy School's Environmental and Natural Resources Program, Chairman of Degree Programs, and Chairman of Ph.D. Programs. In addition, he works as an economic consultant with The Economics Resource Group, Inc., One Mifflin Place, Cambridge, Massachusetts 02138.

He received his Ph.D. (1980) and his Master's (1977) degrees in economics from the University of California, Los Angeles. He is a specialist in the economics of regulation and competition, with particular emphasis on the natural resource, transportation, and financial sectors. He has published, taught, and testified extensively on the regulation of industry in the

KALT/REISHUS

United States. In addition to his research and teaching, he has testified in numerous legal, regulatory, and legislative proceedings concerning matters of competition and regulation and has submitted expert verified statements before the Surface Transportation Board (STB) and its predecessor agency, the Interstate Commerce Commission (ICC), on a number of occasions. He has also provided testimony as an expert on issues of competition and regulation, including the design and implementation of open-access regulation, before various Federal and state judicial and regulatory venues.

David Reishus is the President of The Economics Resource Group, Inc. The Economics Resource Group provides economic consulting services to the public and in numerous legal, regulatory, and legislative proceedings concerning matters of competition and regulation in the private sector, with an emphasis on energy and regulated industries. He received his Ph.D. (1988) and Master's (1983) in economics from Harvard University. Dr. Reishus specializes in applied microeconomic analysis relating to public policy and economic regulation. He has consulted for numerous private and public clients on issues involving the economics of competition and regulation.

We have been asked by the Association of American Railroads to evaluate the economic effect of existing regulation on the performance of U.S. railroads. We have also been asked to consider the appropriateness and likely effect of the imposition of "open access" on the rail transportation industry.

I.B Summary

The major regulatory reforms of the 1970s, culminating in the Staggers Rail Act of 1980, resulted in a transformation of the rail industry. Prior to these reforms, the rail industry was in deplorable financial and physical condition with poor and declining service brought about in large measure by the strictures of intrusive regulation. Since the passage of the Staggers Act, the railroad industry has turned around by almost all measures: productivity has improved enormously, the financial position of railroads and service to shippers have improved, infrastructure investment has increased, and rates to shippers have fallen. The reformed regulatory structure permitted railroads to take actions, including the rationalization of the rail system through merger and consolidation, spin-off and sale of low density lines, and abandonment of unprofitable track, that have led to these improved outcomes. Shippers and the economy as a whole have benefited from the more efficient allocation of scarce resources.

The rail industry is subject to network economies of scale, scope and density. Railroads require large amounts of capital and infrastructure investment in the rail network and rolling stock; the costs of these investments must somehow be recovered. The capital invested in the rail network is fixed and sunk—literally embedded in the ground—and represents a common resource for all traffic utilizing the network. In these circumstances, the railroad must anticipate the recovery of sufficient revenue to support these fixed and common costs. Any traffic that generates revenue in excess of the variable cost of providing the service contributes to supporting the common, fixed costs. Under current market conditions, differential pricing across shippers is necessary to satisfy the opposing goals of competing with trucks and other shipper alternatives while obtaining revenue to provide railroads an adequate return on their investments.

Other industries in the U.S. and abroad, such as natural gas, electricity, and telecommunications, have adopted or are adopting complex regulatory systems in which access to one regulated portion of the vertical industry is required to be provided to other, competitive segments of the vertical industry. Apart from difficult transition problems, these forced-access regimes require the development of a new regulatory scheme that needs to resolve numerous pricing and operational issues related to access.

Unlike natural gas and electricity, where the delivered commodities are generally fungible and service attributes differ primarily along narrow volume and interruptibility dimensions, railroads must move specific goods from specific origins to specific destinations while contending with differing service and schedule requirements. Under the existing system, individual railroads organize, coordinate and prioritize operations and schedules internally or in negotiation with connecting railroads to meet the shippers' differing price and service demands. An access regime, however, would need to impose intrusive and complex regulatory rules to establish operational and service priorities that would carry a strong probability of less efficient outcomes affecting all shippers.

Railroads and their shippers currently benefit from significant economies of density arising from both the rail network and rail operations. Forced access (or even its threat) introduces uncertainty regarding whether railroads will realize financial rewards from investment in infrastructure, thereby reducing the incentive for new infrastructure investment. Forced access would also require complex ratemaking that would have to be sensitive to the competitive conditions affecting different types of traffic while adequately compensating for the use of the

rail network. Experience from other industries such as natural gas, electricity, and telecommunications suggests that effectively resolving these pricing and coordination problems in the rail industry would be a complex and possibly fruitless regulatory task.

II. EVOLUTION OF CURRENT REGULATORY SYSTEM

The deplorable state of the railroad system a mere 25 years ago should not be forgotten as new options for regulation are evaluated. Poor service quality, high accident and damage rates, and inefficient routes and rates caused many shippers to desert railroads for other modes of transportation. A number of railroads, accounting for a significant portion of the U.S. rail system, were in bankruptcy, and many suffered from revenues inadequate to cover the capital investments necessary to maintain a rail infrastructure.¹ Railroads, subject to pervasive regulation, endured long and extensive reviews in order to alter rates, adjust joint rates and routes, construct new lines, abandon existing unprofitable lines, or spin-off or merge rail operations. In short, the rail industry was locked into an extensive and rigid regulatory system that ignored the reality of intermodal competition and failed the rail industry, shippers, and the economy.

Recognition of the uncertain future of the industry under pre-Staggers regulation led to the major regulatory reforms of the 1970s and the passage of the Staggers Rail Act of 1980. These reforms established the regulatory foundation that allowed a rejuvenation of the U.S. railroad industry. In broad terms, the reforms addressed the competitive concerns of shippers by providing not only protections to shippers, but also flexibility in rates, operations, and system

¹ See Verified Statements (V.S.) of Craig F. Rockey on behalf of the Association of American Railroads.

rationalization to railroads. Railroads used this flexibility to respond to competitive forces and attempt to earn financial returns adequate to recover investment costs. More specifically, these reforms provided for:

- The elimination of rate equalization, mandatory maintenance of inefficient interchanges, routes and joint-line rates, and general rate reviews.
- Flexibility in rate setting, allowing railroads to set rates in response to competition in order to attract new traffic and to obtain revenue that contributes to the joint and common fixed costs of the rail network.
- Privately negotiated contracts that allow railroads to offer price and service conditions tailored to meet the needs of individual shippers and, in the case of long-term contracts, to guarantee railroads a predictable base of traffic and revenue.
- The economic incentive and opportunity for railroads to make investments in infrastructure and service to compete among themselves and with other transportation alternatives.
- Opportunities for system rationalization through the streamlining of requirements for the abandonment of unprofitable lines and for the sale or spin-off of rail assets to short-line railroads.
- The capture of economies of scale and scope through merger and consolidation under regulation ensuring the maintenance of competition.
- Protection of shippers provided through regulation of maximum rates for market dominant traffic, protection of essential services in mergers, and prohibition on cancellation of efficient of interline routes.

The reformed regulatory system replaced the failed system of extensive and intrusive regulation. This new framework allowed railroads to make private decisions regarding operations, investments, and pricing in response to market forces, within some regulatory constraints to protect shippers. This reformed system is consistent with the fundamental economics of the rail industry and the market forces affecting it. Railroads, as discussed in more detail below, benefit from significant network economies of density, scope, and scale. Reformed regulation regarding mergers (as reflected in ICC's merger policy statement), spin-offs and

abandonment of unprofitable rail lines enables railroads to take advantage of fundamental economic efficiencies. Differential pricing allows railroads to compete more effectively and thereby recover the large joint, fixed costs of the rail infrastructure over a broader customer base.

The performance of the rail industry following the passage of the Staggers Act represents a dramatic turn-around from the pre-Staggers era. In response to the opportunities provided by reformed regulation, the railroad industry:

- reduced average rates in real and nominal terms
- improved productivity of labor and capital
- rationalized the route system and ownership structure in the industry
- increased capital spending on infrastructure
- improved service quality
- improved the financial outcomes for railroads.

Some of these results are summarized in Figure 1.² Nearly all measures available demonstrate the improvements in the rail industry that have benefited shippers, railroads and the economy.

Increased efficiency and flexibility to adjust service and pricing provided by the post-Staggers regulatory system have bolstered railroads' capacity to compete with other modes of transportation. Increasingly, rails are able to compete with trucks and barges, particularly for long-haul traffic. Railroads have adopted innovative strategies to provide appropriate service and prices that meet shipper demands. The expanded use of relatively low-cost unit trains, investments in infrastructure to handle double-stack intermodal trains with prioritized dispatch and scheduled service, and car-ordering systems such as the BNSF Certificate of Transportation program which provides a means by which grain shippers can purchase a reservation for

² See Rennie and Kaulbach V.S. and Rockey V.S. for a detailed analysis of post-Staggers performance.

Figure 1
**IMPROVEMENTS IN RAIL INDUSTRY PERFORMANCE
SINCE THE STAGGERS ACT**

<i>Productivity Measure</i>	1980	1996	% Change
<i>Thousands of Revenue Ton-miles/</i>			
Freight Service Employee	2,100	7,500	257%
Mile of Road Operated	5,199	10,704	106%
Locomotive	32,710	70,371	115%

<i>Average Rates</i>	1982	1996	% Change
Revenue/Ton-mile (Nominal\$)	\$ 0.048	\$ 0.042	-13%
Revenue/Ton-mile (Real \$87)	\$ 0.048	\$ 0.027	-44%

<i>Intermodal Volume</i>	1980	1996	% Change
Trailers & Containers	3,059,402	9,343,762	205%

Source: Productivity Measures & Intermodal Volumes - AAR, Railroad Ten-Year Trends, (1988, 1990, & 1996);
1997 Railroad Fact Book.
Average Rates - STB, Office of Economics, Environmental Analysis and Administration

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guaranteed rail transportation service are merely three examples of actions taken by railroads to meet the service and price needs of shippers. Despite the enormous improvements in the price and quality of rail service, however, railroads have made only modest inroads against competing transportation alternatives.³

In an effort to improve their competitive position and financial standing, railroads also have reorganized and eliminated uneconomic and redundant assets. Since the passage of Staggers, consolidation of a number of railroads has created expanded rail networks. In their regulatory oversight role of rail mergers, the ICC and STB have conscientiously protected rail-on-rail competition. Streamlined rail systems have enabled railroads to exploit network economies of scale, scope and density, thereby increasing efficiency and reducing costs while maintaining rail competition.

Despite these impressive improvements, the financial health of the railroads is only slowly improving. The measured returns on equity and investment are low relative to those in other industries. In no year since Staggers has the measured return for the rail industry achieved its cost of capital.⁴

III. NETWORK ECONOMIES IN THE RAIL INDUSTRY

To understand the potential impact of competitive access policies in the rail industry, it is necessary to understand the underlying economics of the industry and how the existing regulatory system takes account of them. As a network-based industry, railroads are subject to

³ See *Darius Gaskins V.S.*

⁴ See *Rockey V.S.*

the network economies of scale, scope and density. Railroads are also subject to significant competition from other railroads and other modes of transportation. The existing regulatory system provides railroads the flexibility to make price and service decisions in response to market conditions. Through these private business decisions, railroads attempt to collect sufficient revenue to sustain the joint costs of the network. As part of that system, protections are in place so that no shipper bears an unreasonable or uneconomic portion of those joint costs.

The rail industry is highly capital intensive and subject to large sunk, fixed costs. Once put in place, the large below-the-wheel costs of the rail network (right of way, roadbed, ballast, track, yards, signals, terminals, dispatching systems, etc.) have, for the most part, no other economically significant use except to support rail transportation. These sunk, fixed assets are used in common by trains serving different shippers, commodities and locations. As such, the costs of these assets are joint costs generating economies of scope across different routes and traffic segments. Payments based on the variable cost of maintaining the track and related systems associated with a train's operation would fall far below that necessary to compensate for these large fixed and sunk costs. The rail assets benefit all shippers using the system; some method must be found to pay for these assets and to fund and support investments in maintenance, enhancement and expansion of the infrastructure.

Network economies also arise from the scope and efficiency of the rail network. In general, a larger network will be more valuable to shippers on that network. To the extent that rail mergers and restructuring permit a larger rail network to integrate effectively into a single

firm, rail transportation can be provided at the same or a better service level at lower cost.⁵ This integration may thus attract more traffic and reduce further the average cost of providing service. The consolidation of the rail industry through a number of predominantly end-to-end rail mergers since the Staggers Act appears to be driven in part by the railroads' desire to reap the benefits of economies of scale and scope.⁶

Economies of density are frequently used to describe one aspect of rail economics. Until congestion problems arise, greater amounts of traffic carried on a rail segment decrease the average cost of the traffic because the sunk and fixed costs associated with that line are spread over a larger base.

Economies of density and other network economies are associated not only with the below-the-wheel costs, but also with rail operations. In general, higher densities on the network result in more efficient use of capital—such as locomotives and rolling stock—and labor.⁷ Higher density translates into more frequent train service. Until congestion becomes a problem, increased density will usually require a less-than-proportional increase in rolling stock and labor. At higher densities, locomotives and cars generally can achieve higher utilization and a proportionally smaller reserve of labor is required to maintain schedules and to cover unplanned

⁵ At the same time railroads have been expanding the scope of mainline operations, they have sold off numerous, low-density lines to other operators. This is consistent with rail economics, as the shortlines can provide a quality-of-service and cost combination on low-density operations not possible within the larger railroad. In this case, coordinating limited amounts of interchange traffic across shortlines and mainline railroads leads to a more efficient outcome than internalization within the more complex railroad.

⁶ Caves, Douglas W., *et al.*, "Network Effects and the Measurement of Returns to Scale and Density for U.S. Railroads," in Andrew F. Daughety, ed., *Analytical Studies in Transport Economics* (New York: Cambridge University Press: 1985), at 97-120; Wilson, Wesley, "Cost Savings and Productivity in the Railroad Industry," *Journal of Regulatory Economics*, Vol. 11, (1997) at 23.

⁷ Wilson, *op. cit.*, at 38; and Rockey V.S.

contingencies. For many shippers, higher quality service associated with increased train frequency, e.g., once-a-day service versus once-a-week service, is of great value and results in economically more valuable outcomes to shippers even in the absence of cost improvements by the railroad.

Unlike many transportation and transmission industries, such as natural gas, electricity, and certain other commodity pipeline operations, cargo carried by railroads is not fungible. It is important that the specific goods of a shipper arrive at the appropriate destination. Thus, in trying to move all shippers' traffic from origin to destination in a cost-effective manner that meets the varying service needs of every shipper, railroads must solve a highly complex coordination problem. For example, intermodal traffic tends to be much more time and schedule sensitive than say, coal or certain general merchandise traffic. As a result, railroads have established complex operations that attempt to balance the needs of all of their shippers and are constantly deciding which trains should have priority and which traffic gets switched first in order to meet schedules, where to direct locomotives and rolling stock, and what action to take when unplanned contingencies occur.

Decisions about how to coordinate operations and allocate resources can be made in three ways: (1) within a firm through managerial discretion; (2) between firms through negotiation, contracting and the use of markets; or (3) by government through regulatory intervention. In many circumstances, vertically-integrated firms with significant scope of operations may be more efficient in making decisions and allocating resources than a number of smaller, vertically-disintegrated firms that must coordinate decisions through negotiation or the use of market

mechanisms.⁸ Which method is more efficient will depend on the relative production and transaction costs and the ability to efficiently use information to arrive at appropriate decisions.

Railroads allocate resources and coordinate multiple decisions regarding scheduling, routing, allocation of rolling stock and power, priority in switching, appropriate blocking, and the like. These decisions interact in ways that affect many shippers and traffic and will be difficult for external observers or market participants to understand or predict. Many of these decisions, therefore, can be resolved more efficiently and at lower cost by managerial discretion within a firm rather than through the use of contracts or other market mechanisms across firms.⁹ These alternative external-to-the-firm mechanisms may involve multiple parties, elaborate contracting that attempts to account for multiple contingencies, or simplifications to the decision-making process that ignore or overlook important economic interactions. For example, in locations or operations where congestion is a problem, it is important that the increase or decrease in congestion be accounted for in individual routing and scheduling decisions. Vertically-integrated railroads of sufficient size and scope that can internalize the impact of congestion are more likely to make appropriate decisions, such as scheduling trains or investing in new capacity, than would occur through negotiation among smaller or disintegrated railroads.

Voluntary negotiation and contracting across firms can still capture many of the efficiency benefits of a transaction. Separate firms that mediate decision-making through negotiation, market prices, or contracting are commonplace, even in the railroad industry. The

⁸ Milgrom, Paul, and John Roberts, *Economics, Organization and Management*, Chapter 4 "Coordinating Plans and Actions" (Englewood Cliffs, NJ: Prentice Hall, 1992); and Williamson, Oliver, "The Vertical Integration of Production: Market Failure Considerations," *American Economic Review*, 61(2):112-23 (May 1971) at 113-114.

⁹ Coase, R.H., "The Nature of the Firm," *Economica*, (November 1937) at 386-405.

growth of shortlines arises from the recognition that smaller, more nimble companies can serve much lower density traffic more effectively than mainline railroads. These efficiencies are maintained as the mainline and shortline reach negotiated and marketplace solutions for coordinating and pricing interchange and operations.

Voluntarily negotiated arrangements among railroads about access, for example, are more likely to reach efficient bargains than those imposed by regulation. In negotiation, participants with economic stakes in the outcome have every incentive to capture all the available efficiency benefits, within the limits of what can be obtained through contracting. Terms and conditions imposed by an external regulator are unlikely to obtain the efficiencies in the transaction that can be achieved through private negotiation.

The current organization and regulation of the rail industry in the U.S. is consistent with the fundamental economics governing that industry. Consolidation has created large-scale railroads capable of capturing economies of scale, scope and density and internalizing many operational decisions to avoid transaction cost inefficiencies across firms. As part of these consolidations, regulatory policy has carefully attempted to preserve rail- to-rail competition where it might otherwise be eliminated in mergers.

A fundamental economic problem of railroading is recovery of the joint costs involved in providing rail service. Railroads face significant competition in attracting traffic and must compete directly against trucks, barges and other railroads. The strength of these competitive forces will vary by commodity and shipment, thus implying differing levels of acceptable price and service combinations. The current regulatory framework adopts policy that is consistent

with economic efficiency and that permits railroads to use differential pricing to respond to competition across commodities and shippers.¹⁰ Such a policy permits railroads to attract any traffic that will contribute to the joint costs of operating the rail system. Existing regulation (as embedded in the competitive market pricing principles) is intended to prevent railroads from charging rates in excess of what an efficient competitor would otherwise charge on that traffic.¹¹

IV. FORCED ACCESS IN THE RAIL INDUSTRY

The overall success of the rail transportation industry in the post-Staggers era is not without problems. The recent severe service disruptions on the UPSP, arising from capacity and operational constraints, demonstrate the importance of rail transportation to the economy. These disruptions have spurred calls for reform as shippers have suffered from repeated delays and service failures. Shippers have used these service problems and the improved financial performance of railroads as the occasion to voice concerns about the competitive options and regulatory relief available under the current regime. Shippers who are paying rates that provide greater-than-average compensation for the fixed and joint costs of the rail system may be particularly vocal. Not surprisingly, one approach discussed is some form of competitive or open-access regulation.

Forced competitive access, also known as open access, is a regulatory approach that has been adopted in other transportation or network-based industries in the U.S. and in the rail

¹⁰ Kessides, Ioannis N., and Robert Willig, "Restructuring Regulation of the Railroad Industry," *Public Policy for the Private Sector*, Note No. 58, The World Bank (October 1995).

¹¹ Interstate Commerce Commission, Ex Parte 347 (Sub No. 1) *Coal Rate Guidelines*. (Issued: August 8, 1985). and Surface Transportation Board, Ex Parte 347 (Sub-No. 2), *Rate Guidelines - Non-Coal Proceedings*. (Decided: December 27, 1996.)

industries of other countries. Under open access, a regulated vertical industry is unbundled into one or more segments that are treated as competitive and subject to little or no regulation. These unbundled segments purchase services from (or access to) a more-heavily regulated segment of the industry. For example, natural gas pipeline companies previously operated as merchant pipelines that purchased, moved and then resold gas as regulated monopolists. Under FERC Order 636, pipeline companies were required to unbundle gas transportation services and sell capacity rights for transportation under regulated terms and conditions to multiple competing shippers who could then arrange for the purchase, sale and marketing of natural gas.¹² While the natural gas industry has had the longest experience with open-access regulation in the U.S., similar efforts are being made in other industries: electricity transmission is being unbundled from power generation and distribution, and in telecommunications the FCC is trying to unbundle local access switching and other services to permit competition in the provision of local telephone services.¹³

While we are not responding to specific "open-access" recommendations for the rail industry, recent discussions reflect an intention on the part of certain shipper interests to inject additional competition in the rail industry through forced access. We take competitive access as meaning that an existing railroad would be forced to grant one or more other railroads, shippers, or some new entities rights to run trains and provide service to shippers over the existing

¹² Federal Energy Regulatory Commission Order No. 636 (Issued: April 8, 1992).

¹³ Federal Energy Regulatory Commission, 18 CFR Parts 35 and 385, Order No. 888 (Issued: April 24, 1996). Telecommunications Act of 1996, Pub. L.A. No. 104-104, 110 Stat. 56 (1996).

railroad's track under rates, terms and conditions imposed by a regulator.¹⁴ This has the effect of unbundling, at least to some limited degree, the above-the-rail operations from the below-the-wheel services.

Both the existing market-based regulatory system and a forced-access system must provide some mechanism to allow for recovery of the fixed and joint costs incurred in the rail industry. There is no free lunch. The existing regulatory structure and any proposed forced-access system must raise revenues sufficient to support the rail network. If the rail industry is earning normal or less than normal returns under the current market-based regulatory system, access regulation that significantly reduced the revenue available to railroads would be a large step backwards with respect to raising the capital needed for infrastructure expansion and enhancement. The railroad industry needs to make investments in infrastructure that have an opportunity of earning a reasonable rate of return. Unless the government is willing to subsidize such investment from tax revenues, these revenues must come from shippers.¹⁵

The ability to recover costs in other open-access industries did not initially appear to be as severe an issue as it is for railroads. The natural gas pipeline industry was, at one time, viewed as having a strong natural monopoly, and as such, would have no difficulty selling transportation at regulated rates sufficient to cover their large fixed costs. Competition from new pipelines and other energy options has rendered that assumption invalid in certain markets.

¹⁴ The STB currently (and formerly the ICC) has the authority to impose competitive access under certain conditions. There have been very few requests for relief, and the regulators have found none justified on the facts.

¹⁵ Major competing transportation systems in the U.S., the inland waterway system used by barges and the interstate highway system used by trucks, do receive large infrastructure investments out of taxpayer funds. Similarly, changes in rail regulation abroad are frequently motivated by the desire to reduce government subsidies to state-owned or -supported railroads. Rennie and Kahlbach V.S.

Thus, regulated gas pipelines, like railroads, now have concerns about their ability to recover fixed costs and to attract investment.¹⁶ Similarly, electricity transmission, which is just now being unbundled, is generally viewed as having sufficient demand to recover their historical costs through regulated rates. Regulatory changes in the electricity industry are anticipated to generate large stranded costs—costs of existing assets that would have been recovered through rates under the old regime, but for which revenues are not expected to be available under the new proposals. For the most part, stranded costs resulting from electricity deregulation are assumed to be recoverable from charges on the use of the transmission system payable by electricity customers captive in their need to utilize the electricity transmission grid.¹⁷ Given the competition faced in the rail industry, there may not be a comparable base of customers captive to railroads from which to recover the stranded costs. The captive shippers who may anticipate the greatest gains through lower rail rates associated with favorable access charges are the same shippers from whom the stranded costs would need to be recovered.

A second problem confronting open-access regulation is that it must provide a mechanism for pricing the access that users purchase. This task can be enormously difficult. Currently in the rail industry, railroads are given the flexibility, within various broad regulatory constraints, to set rates differentially across shippers, commodities and routes in order to meet competition and attempt to recover their fixed and joint costs. Railroads also negotiate to try to provide value-added services of priority, timeliness, loss control, and the like. Under access

¹⁶ Barcella, Mary Lashley, "How: Commodity Markets Drive Gas Pipeline Values; Even a Monopoly Won't Confer Market Power" *Public Utilities Fortnightly* (February 1, 1998).

¹⁷ Fox-Fenner, Peter, "Chapter 16: Stranded Costs," *Electric Utility Restructuring: A Guide to the Competitive Era*, Public Utilities Reports, Inc. Vienna Virginia, 1997.

conditions, regulators will be required to establish rates for any forced access granted.¹⁸ Thus, regulators will be drawn into the difficult problem of setting rates that recover the fixed and joint costs. If regulators move toward a uniform rate structure, it will most certainly revert to a situation in which railroads lose revenues from all sides. While highly competitive traffic (and any contributions to fixed costs earned on that traffic) will be lost to competing alternatives, existing high-volume, high-contribution traffic will make reduced contributions to fixed costs due to reduced access rates. Both effects would tend to reduce the financial health of the rail industry and limit future infrastructure investment. Implemented on a large scale, such an outcome could represent an enormous, regulation-imposed expropriation of railroad capital.

While not necessarily impossible in theory, solving the rate-setting process for access in the U.S. railroad industry is far more complex than in most other industries where it has been tried. As the history of the rail industry demonstrates, the rate-setting process can become politicized and enormously difficult. Since access regulation is trying to allocate costs that are essentially joint, there are no clear economic guidelines, apart from differential pricing such as used by railroads (subject to a standalone cost test) under the existing regulatory structure, to establish a benchmark for the fixed and joint cost recovery. Experience prior to Staggers in the rate-setting process and regulatory attempts to establish rates for required rail access since Staggers do not bode well for the exercise. Attempts to establish by regulation open-access rates

¹⁸ An extreme proposal would be to require the complete divestiture of the below-the-wheel system and then permit the new "RailTrack" companies to set access prices under constraints similar to that observed currently by railroads. Such privately set access prices would be unlikely to satisfy most critics of the rail industry, as it would tend to replicate efficient pricing structures observed today.

on a widespread basis in the rail industry are likely to be contentious, difficult, time-consuming and possibly futile.

The experience in the telecommunications industry since the Telecommunications Reform Act of 1996 is instructive. Attempts to price the components of local phone access service have proven to be enormously difficult and have resulted in a morass of litigation with little progress made to date. Apart from the litigation over jurisdiction and takings issues, the ability to apply pricing principles to component services of an industry subject to significant network economies has proven frustrating due to strong disagreements about appropriate pricing.¹⁹ While the final chapter on this reform is not written, the results so far do not provide an encouraging example for the railroad industry.

A third general problem in access regulation is the need to monitor and possibly regulate the "competitive" sector of the industry. Forced access requires that a vertically-integrated industry be disintegrated into segments, at least one of which is required, under strict regulation, to sell access to the other segments of the disintegrated vertical chain of production. These other, less regulated segments are usually treated as workably competitive. In natural gas, and as part of the evolving electricity market, strict rules or codes of conduct have generally been established to control how the owner of the regulated facility can make use of the facility in competition with others who may purchase access. In order for forced, regulated access to function, elaborate

¹⁹ Harris, Robert, and C. Jeffery Kraft, "Meddling Through: Regulating Local Telephone Competition in the United States," *Journal of Economic Perspectives* (Fall 1997 11:4), at 93-112.

rules have been established that govern the terms and conditions under which the incumbent is allowed to transact with other segments of the industry.²⁰

Similarly, there have been questions as to whether the purported "competitive" segment of the industry is truly competitive. For example, in electricity, regulators are coping with concerns raised about market power in power generation. In the railroad industry, it is not clear that the network economies of scope and density will permit widespread competition in a world with access. The United Kingdom, which has implemented one of the most radical rail access attempts in the world, has been unable to sustain multiple operators providing freight rail service. At least in the U.K., there is not strong evidence that rail operations can sustain a competitive market structure.²¹

The economies of density in railroad operations imply that multiple operators in an open-access system will tend to increase overall use of resources and costs of providing service. Open access may shift these higher costs onto shippers who are not utilizing access. For example, to the extent that use of access by a shipper reduces the traffic density for the incumbent railroad, operating costs are likely to increase. With economies of density in rail operations, two carriers that split the traffic on a line are likely to require more total resources in terms of crews, locomotive power, and cars in order to maintain the same total quality of service than would a single operating railroad. If access rates to some shippers are sufficiently favorable to bring in another railroad, other shippers lose twice through both higher operating costs from reduced

²⁰ Federal Energy Regulatory Commission Order No. 636 (Issued: April 8, 1992). Federal Energy Regulatory Commission, 18 CFR Parts 35 and 385, Order No. 888 (Issued: April 24, 1996).

²¹ Rennie and Kaulbach V.S.

economies of density and reduced contribution to the railroad's fixed costs paid under the reduced access rates.

The current regulatory regime allows vertically-integrated railroads to coordinate complex decisions about operations affecting all shippers with enhancements to the rail network infrastructure. Many aspects of railroad operations—establishing routes and priority of service, deployment of assets, scheduling trains and crews to best meet customer demands—are difficult problems that are generally best resolved by coordinated decision-making internal to a railroad firm or through voluntary arrangements between railroads that can account for the tradeoffs specific to the situation. Any tradeoffs, for example, in establishing train frequency or priority need to account for the effect on other shippers and on the operation of the railroad as a whole. Integrated railroads, because they deal with all shippers and register the demands of shippers in response to changes in price and service, are in the best position to make the appropriate economic tradeoffs.

Customizing service to shippers is inherently complex. This requires basic business judgment in strategic and day-to-day operations. Should train A or B make it through the yard first? How should blocks be built, and where? How should train schedules be established, and what traffic should get priority? For the most part, railroads make these operational and coordination decisions internally, balancing differing customer demands for price and service attributes with the costs imposed on the railroads' network as a result of these decisions.

One of the attributes of the network economies driving consolidation in the railroad industry is the ability to provide efficient and high quality service more effectively in a larger

network controlled by a single railroad rather than through coordination across multiple carriers. The benefit of single-line service, in terms of improved service perceived by shippers, is the result of a single railroad being in a better position to make operating, marketing, and customer service decisions and take actions than if multiple railroads need to coordinate decision-making, including scheduling, blocking, and interchange with multiple railroads.

Under forced access, the economies of scope and density inherent in rail operations may lead to duplication of costs and reduced service. In some circumstances, multiple parties utilizing open-access rights will find it difficult to coordinate and negotiate efficient scheduling and operations. To address this problem, some form of operational control mechanism may need to be established for setting schedules and priorities in switching, and responding to contingencies. Forced access—~~not~~ worked out as part of mutually-agreeable business strategies—would take the control out of the hands of the parties that make the business decisions that determine rail quality and cost. The result is likely to be a failure in coordination that could cause deterioration of rail service quality and could put the regulator in the position of centrally planning rail service, or at least imposing and enforcing rules of operation that could not be as flexible and market-responsive as those determined by the railroads themselves.

Finally, under either the current regulatory system or open access, a mechanism needs to be provided to fund new investment in infrastructure. Under current rail regulation, capital investment is, for the most part, at the discretion of railroads, which in recent years have accepted the risk that these capital costs can be recovered through rates. The vertically-integrated railroad can, through its understanding of shipper demands for rail service and its own operations, gain

insight into what infrastructure investments will meet the market test—i.e., generate additional revenue from shippers that is expected to be available to compensate for the capital investment.

Under regulated open access, expansions in infrastructure by the regulated segment of the industry would generally require ratemaking approval to establish how rates will change and who will pay them. For example, if a railroad spends \$10 million to upgrade some yard facilities, a decision will need to be made about how these costs will be allocated across shippers through the access rates. The value of the upgrade is unlikely to be uniform among shippers. Similarly, as in other utility regulation models, investment proposals intended to enhance the joint network, the costs of which would properly be included in access charges, would require regulatory oversight to ensure that rates reflect only prudent investments.²² While open-access systems are relatively new, providing proper market-based economic incentives for infrastructure enhancement to the provider of the regulated access service is difficult.²³

Where access is efficient and mutually beneficial, voluntary mechanisms already exist to bring it about. Indeed, railroads throughout the country are currently involved in a variety of privately-negotiated access arrangements through switching, haulage and trackage rights. Where there are significant efficiencies to be gained through negotiation, the railroads have the incentive to take advantage of them. For example, the Norfolk Southern has contracted for a variety of access rights that permit it to operate more efficiently and save resources by arranging payment for use of others' tracks and related services rather than by using inefficient routes or making

²² Federal Energy Regulatory Commission, Pricing Policy for Transmission Services (Issued: October 26, 1994).

²³ Thompson, Louis, "The Benefits of Separating Rail Infrastructure from Operations," *Private Sector Note No. 135*, The World Bank Group, Finance, Private Sector and Infrastructure Network.

large new investments.²⁴ As part of the proposed Conrail transaction, CSX and NS have proposed large shared asset areas. Extensive negotiation representing the private give-and-take of competing business interests went into creating the operating plan, financing and sharing arrangements. Similarly, BNSF and UPSP have recently proposed the establishment of joint operations and joint dispatch for Gulf Coast Operations.²⁵ These outcomes represent the considered judgment of experienced railroad managers balancing the myriad financial and operational considerations necessary for efficient sharing.

Given the difficulties of establishing and maintaining an open-access system in the rail industry under current economic circumstances the case for widespread open-access regulation is problematic at best. An efficient pricing system would maintain differential value-of-service pricing in order to fund the fixed and joint costs of the rail network; the alternative is to permit some favored few to obtain rate relief through the guise of access and to the detriment of other shippers. Access regulation would impose significant regulatory cost and introduce uncertainty that would tend to reduce future investment; and while it might introduce some additional competition into rail operations, it would tend to reduce existing network economies and increase costs. Open access in the rail industry could lead to intrusive regulatory intervention and inefficient outcomes. Indeed, some observers of access regulation in other industries point to the regulatory structure in the rail industry as a possible model for the solution to their problems.²⁶

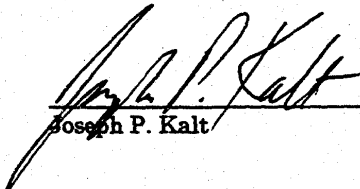
²⁴ Murphy, Tim, "Managing Capacity for Growth: Short of Capacity? Why not share infrastructure?" *Progressive Railroading*, October 1995.

²⁵ "UP/BNSF Reach Agreement," *PR Newswire*, February 13, 1998.

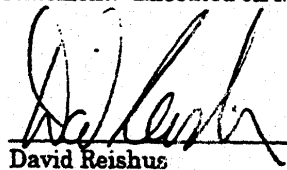
²⁶ Harris and Kraft, *op. cit.*, at 110.

VERIFICATION

I, JOSEPH P. KALT, verify under penalty of perjury that the foregoing is true and correct. Further, I certify that I am qualified and authorized to file this Verified Statement. Executed on March 24, 1998.


Joseph P. Kalt

I, DAVID REISHUS, verify under penalty of perjury that the foregoing is true and correct. Further, I certify that I am qualified and authorized to file this Verified Statement. Executed on March 24, 1998.


David Reishus

VERIFIED STATEMENT OF INVESTMENT BANKERS
AND SECURITIES ANALYST

We are investment bankers and a securities analyst with responsibilities and expertise in rail industry matters. Our position and background are described in Exhibit 1 to this statement. We previously submitted a verified statement to the Board in the so-called "Bottleneck" proceeding in October 1996. The Association of American Railroads asked us to submit this verified statement in response to the Surface Transportation Board's request for comments on access and competition issues in the rail industry. We understand that the Board is seeking to develop a record on these issues to assist it and Congress in evaluating proposals for modifying the existing structure of economic regulation governing railroads. In particular, some shipper groups are advocating new regulatory approaches that would require the railroads to provide competitors with access to their facilities.

As explained below, we believe that a regime of forced access would impede the railroads' ability to raise capital and would curtail new investments in railroad infrastructure at a time when new investments are needed. One of the favorable consequences of the Staggers Act was that it stimulated investments that created stronger and more efficient railroads. The railroads and their shippers have benefited from these investments as operating costs have declined. Still more infrastructure investment is needed.

We believe that a regime of forced access would be unwise because it would discourage the very investments that are needed to improve railroad operations and to respond to the growing demand for railroad service in this country. Forced access would undermine investor confidence in the nation's railroads and would therefore reverse the progress made under deregulation toward improved efficiency and earnings.

Board Regulatory Policy Should Encourage Infrastructure Investment

In our prior statement, we discussed the benefits that resulted from deregulation of the rail industry. We noted that the Staggers Act of 1980 and the market-oriented regulatory policies implemented since then have made it easier for the railroads to attract capital on competitive terms. With deregulation, investors have become more willing to supply capital to the industry because they are more confident that the railroads will have the opportunity to earn competitive returns. The railroads have made good use of these funds. Investments by the railroad industry since the Staggers Act have led to enhanced productivity, lower costs, improved service, and lower rates. In short, deregulation of the rail industry has benefited both the railroads and the shippers that use the railroads.

We believe it is important to continue the deregulatory policies ushered in with the Staggers Act. Deregulation stimulated investment in railroad infrastructure but more infrastructure investment is needed. Shipper demand for railroad service is increasing and new facilities will need to be put into service in order to continue improving railroad productivity.

The availability of adequate funding for infrastructure development and maintenance is critically important to the viability of any transportation system. The railroad system in this country is unique in that it relies entirely on private capital for infrastructure funding. Other transportation systems, especially trucks, rely heavily on public funds to maintain their infrastructure. Taxpayers benefit from a privately funded railroad system because they are not asked to support infrastructure spending. But to preserve this benefit, it is important to avoid regulation that interferes with the ability to raise capital or that unnecessarily increases the cost of capital.

Forced Access Regulation Would Curtail Investment And Impair Investor Confidence

We do not address specific forced access proposals here. However, we understand that the basic idea behind forced access is that the Board would be given increased authority to order railroads to make their facilities available to competing railroads. We believe that regulatory changes of this type would discourage new investment in railroad infrastructure in a variety of ways.

Most important, investors would be less willing to make funds available for costly infrastructure investments because of the uncertainty that any new investments would generate competitive returns. New facilities might have to be shared with competitors, therefore the revenues generated by those facilities would be less certain. To the extent the railroads could attract capital for infrastructure investment, this uncertainty would increase the cost of raising that capital.

Investor confidence in the nation's railroads would also decline. If the railroads limit their infrastructure spending, investors will question whether the industry is able to continue making progress toward financial health by cutting costs and increasing productivity. While the nation's railroads have become healthier under the current regulatory structure, their level of profitability is still low compared to other industries and they still do not generate competitive returns. Additional investment is needed to bring the rail system up to its full potential and investors will be troubled by any change in regulatory policies that discourages that investment.

Investor confidence in the railroads would also be hurt because of concern over the operating problems that would likely arise under a regime of forced access. Deregulation allowed the railroads to establish efficient routing of traffic, to streamline operations and to eliminate redundancies and unnecessary overhead. Forced access would do away with these

benefits. The railroads would have to establish more elaborate and expensive systems to coordinate traffic movements and their ability to plan their own movements would be impaired. Less efficient operations would reduce cash flows and further undermine investor confidence.

Finally, investors would be troubled by any changes in the regulatory structure that limit the ability of the railroads to price their services in accordance with demand. The pricing flexibility that railroads have under the present regulatory system has generated opportunities to make rail transportation more competitive and to attract more traffic. This has permitted the railroads to improve historically inadequate profitability and to make the investments needed for improved efficiency and service quality. Any regulatory changes that restrict the ability of the railroads to earn healthy revenues would undermine investor confidence and impair the railroads' access to capital.

Conclusion

Market-oriented regulation of the railroads has promoted healthy investment in railroad infrastructure. Railroad productivity has increased, costs have gone down, and shippers have paid lower rates. Additional investment is needed. To encourage those investments, the Board and the Congress should maintain the market-oriented approach. A regime of forced access would discourage investors from making new funds available for infrastructure development and the progress made by the nation's railroads toward financial health in recent years would be reversed.

BIOGRAPHIES

Francis M. Cox, III

Francis M. Cox, III is a Vice President and the Railroad Industry Executive within the Transportation Group of the Chase Manhattan Bank, located at 270 Park Avenue, New York, New York. In this capacity since 1987, he is responsible for the coordinated delivery of corporate finance products and services to the Bank's railroad industry clients. Chase is currently the number one lender to the U.S. railroad industry.

Mr. Cox joined Chase in 1960. He has had over 35 years of experience in a variety of relationship banking, corporate finance and marketing assignments servicing major U.S. and multinational corporations.

Mr. Cox received his B.S. degree from Georgetown University and his M.B.A. degree from New York University.

Edmond L. Lincoln

Edmond L. Lincoln is a Managing Director in the Investment Banking Division of PaineWebber Incorporated, located at 1285 Avenue of the Americas, New York, New York. He is in charge of PaineWebber's investment banking activities for surface transportation companies, principally in the railroad and marine industries. He has been an investment banker for more than 20 years working chiefly with surface transportation companies, first with Kidder, Peabody & Co. Incorporated and then with PaineWebber following the purchase by PaineWebber of portions of Kidder, Peabody in December 1994.

During the past ten years, Mr. Lincoln has been personally involved in the management of about \$17 billion of transactions for public and private corporations in the U.S. railroad industry. In this period, Mr. Lincoln has represented such clients as Atchison Topeka & Santa Fe, Burlington Northern, Southern Pacific, Union Pacific, Conrail, CSX, Norfolk Southern and Amtrak.

Mr. Lincoln received a Bachelor of Arts degree from Harvard College and a Masters in Business Administration from Harvard Business School.

Michael H. Lloyd

Michael H. Lloyd is First Vice President and Senior Railroad and Trucking Industries analyst at Merrill Lynch, located at World Financial Center, North Tower, New York, New York. He joined Merrill Lynch in May 1995. Mr. Lloyd has followed equities since 1972 at H.C. Wainwright & Co., Woolcott Research Associates, Salomon Brothers, and NatWest Securities.

Mr. Lloyd has been analyzing railroads in particular since 1974. He ranked first in Bloomberg's 1995 Analyst Scoreboard for stock pricing skills in transportation and was ranked by Institutional investor as a runner up in rails. Mr. Lloyd is a Chartered Financial Analyst.

Mr. Lloyd received a B.S. degree from the U.S. Air Force Academy and an M.B.A. degree from Harvard University.

Gerald F. Mackin

Gerald F. Mackin is Vice President of the Surface Transportation Group and Director of ABN AMRO North America, Inc., a commercial bank located at 135 South LaSalle Street, Chicago, Illinois. Prior to joining ABN AMRO, Mr. Mackin was Vice President and Senior Banker of the Transportation Division of The First National Bank of Chicago, where he was responsible for clients in the rail, trucking, shipping, airline and aerospace industries. Mr. Mackin has been involved with the transportation industry since 1982 and has completed transactions involving recapitalizations, asset securitizations, debt agency, project finance, commercial paper, medium term notes and public debt issuance.

Mr. Mackin earned his B.A. degree from Fordham University and received an M.B.A. in Finance from Columbia University's Graduate School of Business.

Stephan C. Month

Stephan C. Month is a Managing Director in the Mergers and Acquisitions department of Credit Suisse First Boston Corporation, located at 11 Madison Avenue, New York, New York. For the past two years, he has been Credit Suisse First Boston's account officer for railroad mergers and acquisitions.

Mr. Month joined Credit Suisse First Boston's Mergers and Acquisitions department in September 1986 and has been with Credit Suisse First Boston since then, except for the period September 1991 to July 1993 when he was a Vice President at Lazard Freres. Mr. Month has been personally involved in the following matters involving railroad clients for which Credit Suisse First Boston has acted as financial advisors: the Union Pacific/Southern Pacific merger; Union Pacific Corporation's acquisition of Chicago and North Western

Transportation Company; Union Pacific Corporation's offer to acquire Santa Fe Pacific Corporation; North Carolina Railroad Special Committee assignment; Kansas City Southern's terminated sale of its railroad property to Illinois Central; various financing and advisory assignments for other railroad clients such as CSX and Canadian National; and various railroad privatizations worldwide, including the Mexican railroad.

Mr. Month received both a J.D. and an M.B.A. degree from Harvard University in 1986.

James J. Ryan

James J. Ryan is a Managing Director of Chase Securities Inc., located at 270 Park Avenue, New York, New York. He heads Chase's worldwide practice in strategic advisory services for railroads. Previously a Managing Director and Group Head of Transportation at Salomon Brothers Inc., Mr. Ryan has worked in transportation finance for more than 18 years, raising funds and doing advisory work for such clients as CSX, Union Pacific, Norfolk Southern, Southern Pacific, Kansas City Southern, Conrail and others. Prior to joining Salomon Brothers, Mr. Ryan was a Director of the First Boston Corporation.

Mr. Ryan holds a bachelor's degree from Colgate University and an M.B.A. degree from Columbia University's Graduate School of Business.


VERIFICATION

STATE OF NEW YORK)

ss:

COUNTY OF NEW YORK)

Francis M. Cox, III, being duly sworn, deposes and says that he has read the foregoing statement, that he knows its contents, and that those contents are true as stated.



Francis M. Cox, III

Subscribed and sworn to before me this 23rd day of March, 1998.



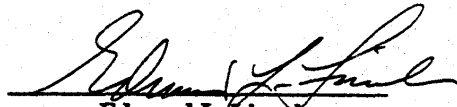
Notary Public

My Commission Expires: _____

ELIZABETH MACOVELLO
Notary Public, State of New York
No. 31-4883391
Qualified in New York County
Commission Expires June 30, 1999

Verification

I, Edmond L. Lincoln, declare under penalty of perjury that the foregoing is true and correct. Further, I certify that I am qualified and authorized to file this verified statement. Executed on March 20, 1998.


Edmond L. Lincoln

*Here to signed before
me this 20th day of
March 1998*



SARAH A. ANTONELLI
Notary Public, State of New York
No. 31-00000000000000000000
Qualified in New York County
Commission Expires 9/15/99

MAR 25 '98 09:30AM MERRILL LYNCH

P.2



Michael H. Lloyd
First Vice President
Global Securities Research
& Economics

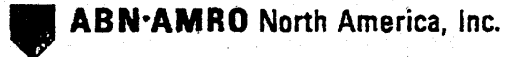
Corporate Strategy
and Research

World Financial Center
North Tower
New York, New York 10281-1319
212 449 2327
FAX 212 449 3105

Verification

I, Michael H. Lloyd, declare under penalty of perjury that the foregoing is true and correct. Further, I certify that I am qualified and authorized to file this verified statement. Executed on March 24, 1998.

A handwritten signature in cursive script, appearing to read 'Michael H. Lloyd', written over a horizontal line.
Michael H. Lloyd

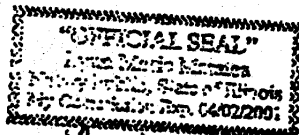


135 South LaSalle Street
Chicago, Illinois 60603
(312) 443-2000

Verification

I, Gerald F. Mackin, declare under penalty of perjury that the foregoing is true and correct. Further, I certify that I am qualified and authorized to file this verified statement. Executed on March 19, 1998.

Gerald F. Mackin



Lynne Marie Harster
3/19/98

Verification

I, Stephen C. Mouth, declare under penalty of perjury that the foregoing is true and correct. Further, I certify that I am qualified and authorized to file this verified statement.
Executed on March 25, 1998.


Stephen C. Mouth

FROM CHASE

(MON) 3. 23 '98 9:53/ST. 9:53/NO. 4860376804 P 3



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James J. Ryan
Managing Director
Global Transportation

March 23, 1998

VERIFICATION

I, James J. Ryan, declare under penalty of perjury that the foregoing is true and correct. Further, I certify that I am qualified and authorized to file this verified statement.

Executed on March 20, 1998

A handwritten signature of James J. Ryan in black ink, written over a horizontal line.

James J. Ryan

**BEFORE THE
SURFACE TRANSPORTATION BOARD**

**EX PARTE NO. 575
REVIEW OF RAIL ACCESS AND COMPETITION ISSUES**

**VERIFIED STATEMENT
OF
WILLIAM J. RENNICK AND
ALLAN E. KAULBACH
VICE PRESIDENTS OF
MERCER MANAGEMENT CONSULTING, INC.
ON BEHALF OF THE
AMERICAN ASSOCIATION OF RAILROADS**

March 25, 1998

Verified Statement of William J. Rennie and Allan E. Kaulbach

Contents

Introduction

Section I The U.S. rail system needs increased capital investment

Section II International trade relies on a healthy U.S. rail system

Section III Case studies of rail restructurings in other countries: the drawbacks of open access

Section IV Adverse consequences of open access on U.S. railroads

Appendix A Qualifications and experience of William J. Rennie and Allan E. Kaulbach

Appendix B Qualifications and experience of Mercer Management Consulting, Inc.

Introduction

This verified statement has been prepared by William J. Rennie and Allan E. Kaulbach on behalf of the Association of American Railroads (AAR).

We are Vice Presidents of Mercer Management Consulting, Inc. (Mercer). We have acted as executives of railroads and have been consultants to railroads and governments worldwide for a combined total of more than 50 years. Our individual qualifications and experience in the railroad industry are set forth in Appendix A. Selected qualifications and experience of Mercer are set forth in Appendix B.

Our purpose in preparing this statement is to provide the Surface Transportation Board (STB) with our perspectives on the issue of "open" or "forced" access as it relates to the ability of the U.S. railroad industry to 1) adequately serve its customers and 2) earn sufficient returns to protect its more than 200,000 employees¹ and assure a growing level of capital investment in infrastructure and equipment.

We are fortunate to be able to bring to this assignment our experience in assisting numerous governments and railroads around the world in restructuring their rail system. Specifically, we have been retained by the following countries and their railroads, among others, to act as the primary advisor in respect to their restructuring efforts:

- Argentina (FA)
- Australia (New South Wales and Queensland)
- Canada (CN)
- Chile
- Colombia
- Mexico (FNM)
- Peru
- South Africa

We have also been retained as consultants to many of the Western European railroads and to various subsegments of the former USSR railroad system.

With this global perspective, we have been able to glean valuable lessons from the various forms and structures that railroad systems can choose to achieve three primary objectives:

¹ *Railroad Facts*. American Association of Railroads, 1997.

- Economic performance, which promotes reinvestment and minimizes the need for government subsidy
- Efficient, responsive, price-competitive service to railroad customers
- Elimination of costly and time-consuming regulatory oversight and the promotion of marketplace decision-making

This statement is organized into four sections:

In Section I, we provide a background for the debate on forced access² by describing the extraordinary progress achieved by the U.S. railroad industry since emerging from industry over-regulation in 1980. The purpose of this discussion is to demonstrate the importance of capital expenditures to the ability of railroads to sustain increases in productivity, and the negative impact that forced access would have on the industry's ability to make future investments.

In Section II, we point out the unique importance of the railroads to U.S. competitiveness in the world economy, and the impact that forced access could have on U.S. export/import capabilities.

In Section III, we provide case studies of railroads and countries around the world that have grappled with the issue of open access, discuss their relevance to the U.S. rail system, and describe the lessons that can be learned from these experiences.

Finally, in Section IV, we provide our opinion as to why we believe that, with respect to the U.S. rail system, the costs of forced access would far exceed any purported benefits. This conclusion does not necessarily imply that forced access has no value. Other countries, faced by different economic and political realities, may require forceful measures to improve highly balkanized rail services or to rehabilitate entrenched government monopolies. But that is not the case in the United States, and forced access is simply not a regime that is consistent with the U.S. system of market-based decision-making and limited railroad regulation.

² Throughout this statement, we use the terms "forced access" and "open access" interchangeably. Forced access occurs where governments impose access by third-party operators on private sector owners of the railroad right-of-way. Open access occurs where the government permits access by third-party operators over government-owned right-of-way.

Section I

The United States has the most efficient and competitive rail network in the world. However, continuing capital investment is critical to sustain U.S. railroad efficiency and competitiveness improvements.

U.S. railroads, after being shackled for 100 years with pervasive regulation, have emerged within the last 15 years to become the most productive railroads in the world. Prior to the deregulation legislation of the 1970s (e.g., 3-R Act, 4-R Act), which culminated in the passage of the Staggers Act in 1980, the U.S. rail system was in a shambles. It took a financial crisis of catastrophic proportions – nine major bankruptcies (including the Penn Central, the largest railroad in the United States)³ – to forge the political will to dismantle a stifling regime of over-regulation.

The results of deregulation have been dramatic:

- Since 1980, U.S. railroads have increased the amount of domestic intercity freight traffic they haul by more than 40 percent (Figure 1).
- Between 1980 and 1996, railroad labor productivity increased by 272 percent, four to six times greater than the 65 percent increase in productivity for European railways and 47 percent increase for U.S. manufacturing during the same period (Figure 2).
- Even in the area of time and service-sensitive intermodal traffic, railroads more than doubled their volume, from 3.1 to 8.2 million shipments, between 1980 and 1996 (Figure 3).

The reasons why railroads have achieved such enormous productivity improvements and increases in traffic volume are readily apparent. Between 1980 and 1996, railroads reduced track and locomotives by 35 percent and 32 percent, respectively; decreased railcar assets by 27 percent; trimmed personnel by 60 percent; and increased freight volume by nearly 50 percent (Figure 4). In addition, mergers and consolidations allowed railroads to achieve further benefits from economies of scale. We believe the following important factors provided the background for this success:

- Productivity gains could not have been achieved without a stable regulatory environment. That is, railroad managers and the capital markets supporting them understood that the “rules of the game” would not be changed. Clear policy signals from the government permitted decisive and effective business decisions by the private sector.
- Productivity improvements occurred without any appreciable government funding. Private capital spending on U.S. railroads leads the world and has relieved U.S. taxpayers of having to provide the billions of dollars in subsidies that citizens of other countries must spend to support their national rail systems.

³ These bankruptcies began in 1969 and ended in the late 1970s.

- Since 1980, U.S. railroads have invested over \$200 billion in track and equipment.⁴
- Since 1990, U.S. railroads have reinvested more in plant and equipment as a percent of revenues than any other major industry sector in the United States (Figure 5).
- Railroad capital expenditures as a percent of operating revenues continue to climb, a trend which, if it continues, bodes well for U.S. shippers and consumers (see verified statement of Craig F. Rockey, Section III).

Massive re-investment in railroad infrastructure *by the industry itself*, using private capital markets, should not go unnoticed by public policy makers, as it underscores an essential truth that emerges whenever Congress or the STB are asked to change the balance of pricing power between railroads and their customers: A stable and limited set of regulatory rules is essential to foster the kind of capital investment that is required for sustained productivity gains by the railroad industry.

As a net effect of productivity gains, railroads have been able to substantially reduce their costs and have passed along the bulk of savings in the form of reduced rates to shippers. Railroad freight rates have declined substantially since passage of the Staggers Act (see Rockey statement, Section VI).

It is widely acknowledged that U.S. railroads have achieved many billions of dollars in cost savings and have passed those savings on to shippers in the form of reduced rates (see Rockey statement, Section VI). Intense competition has caused average railroad revenue per ton-mile to plummet. When measured against freight rates charged by other railroads throughout the developed world, U.S. rail rates are an extraordinary bargain (Figure 6).

Since railroad rates have declined, while unit costs have risen with inflation, U.S. railroads have been able to attain profitability only through increased productivity (see Rockey statement, Section V). As demonstrated in Figure 7, the railroad cost recovery index has soared by 90 percent since 1980, while actual operating costs and yields have declined by about 30 percent. This kind of economic performance is not one typical of an industry with unbridled pricing power and market dominance. Rather, such performance characterizes an industry that faces intense competition with alternative transportation modes and that must struggle constantly to lower costs and improve service – or else face the fate of any business in a competitive environment that fails to innovate.

If sustained productivity gains are critical to future U.S. railroad viability, how is the railroad industry to continue to realize such gains? All the obvious means of increasing productivity – the “low-hanging fruit” – have been already exploited. As depicted in Figure 8, all the avenues that railroads have previously used to increase productivity have either been largely exhausted

⁴ U.S. Industry and Trade Outlook '98: DRI McGraw-Hill.

(labor reductions, system rationalization, mergers), or are unlikely to recur in the future because they were one-time events (tax write-offs, fuel decreases).

In our opinion, the only substantial remaining option for railroads to achieve significant and enduring productivity gains is to increase capital expenditures for newer, more efficient plant and equipment. Capital expenditure will be required in many areas if railroads are to meet the increasingly sophisticated demands of shippers for greater efficiency, improved flexibility and responsiveness, and reduced costs, e.g.:

- Larger railcars that can carry more weight, thereby improving car utilization
- Newer, more efficient locomotives with better power/weight ratios
- Improved track and signaling for faster speeds and increased track utilization
- Port/rail access networks and yards
- Doublestack capability, more efficient yards and switching for interchange and routing efficiency
- Redesign of infrastructure to remove major bottlenecks and capacity constraints.⁵
- Improved information systems. As the supply chains of U.S. manufacturers increasingly rely on real-time information to reduce transportation and inventory costs, railroad information technology must keep pace.

How much capital will be required? We estimate that over the next decade, railroads will need to at least *double* the amount of capital invested in the prior decade in order to lower costs, increase revenues, and sustain economic viability. Evidence of this trend can be seen in the 1998 capital investment plans of leading U.S. railroads: CSXT has stated that it will increase its 1998 capital program by about 25 percent over 1997, to more than \$800 million, according to President and CEO A.R. Carpenter.⁶ And Norfolk Southern announced early this year that it will invest \$903 million in capital improvements in 1998, up 16 percent from 1997.⁷

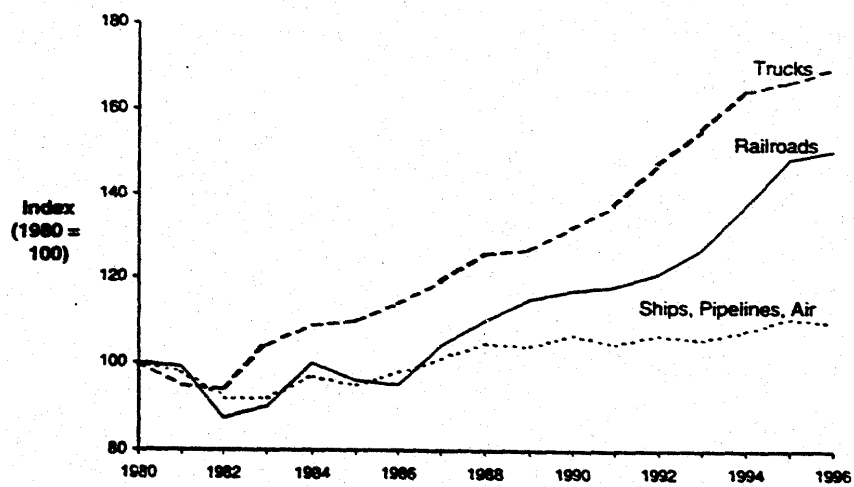
But one major problem remains: Although U.S. railroads have improved their financial performance, *they still do not earn their cost of debt and equity*. As demonstrated in Figure 9, neither industry average return on investment nor return on equity equals the blended cost of capital. The conclusion is obvious: any measures adopted by Congress or the STB that impair the ability of U.S. railroads to achieve acceptable earnings and to raise capital will directly and adversely impact the ability of railroads to sustain productivity improvements.

⁵ For example, the Union Pacific has recently announced that it intends to spend \$2.4 billion in capital improvements in 1998, much of it on infrastructure. ("Spending Spree: '98 Capital Plans," *Progressive Railroading*, March 1998.)

⁶ "CSXT to spend \$800 Million on Improved Service," *PR Newswire*, January 29, 1998.

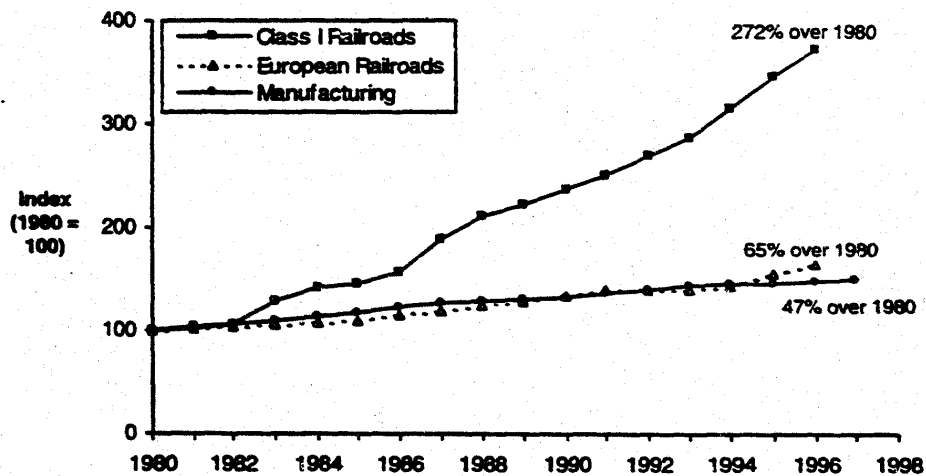
⁷ "\$903 Million in Capital Improvements Planned," *Virginia Pilot*, January 13, 1998.

Figure 1
U.S. Domestic Intercity Freight Traffic by Mode
(1980-1996)



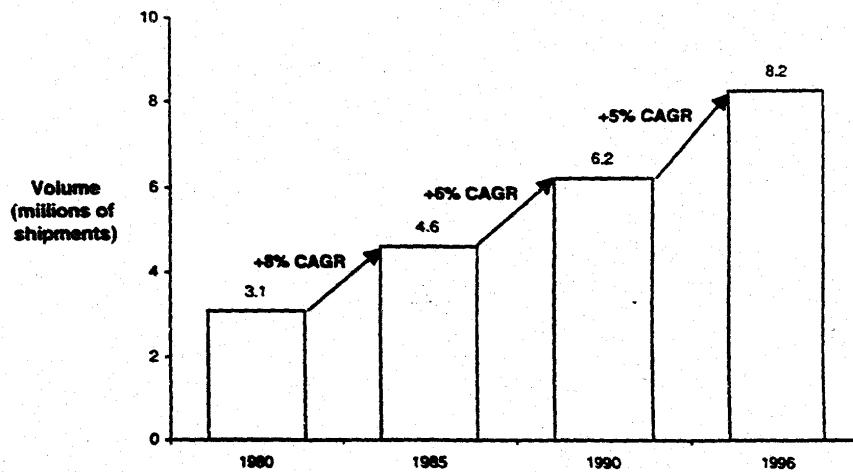
Source: Railroad Facts 1997, Association of American Railroads.

Figure 2
**Labor Productivity of Class I Railroads
 versus U.S. Manufacturing and European Railroads¹**
 (1980-1996)



¹Railroads: Revenue ton-miles per employee; Manufacturing: BLS output per labor hour.
 Source: Railroad Facts 1997, Association of American Railroads.

Figure 3
Growth of Intermodal Volume in the United States
(1980-1996)



Source: Mercer analysis, AAR 10-year trends, various years.
CAGR = Compound annual growth rate.

Figure 4
Key Statistics for Class I Railroads

Measure	1980	1996	Change (1980-1996)
Track network (miles)	271,000	177,000	-35%
Number of locomotives	28,000	19,000	-32%
Number of employees	458,000	182,000	-60%
Number of freight cars ¹	1,711,000	1,241,000	-27%
Freight volume (million ton-miles)	919,000	1,356,000	+48%

¹Includes Class I, car companies, shippers, and all other railroads.

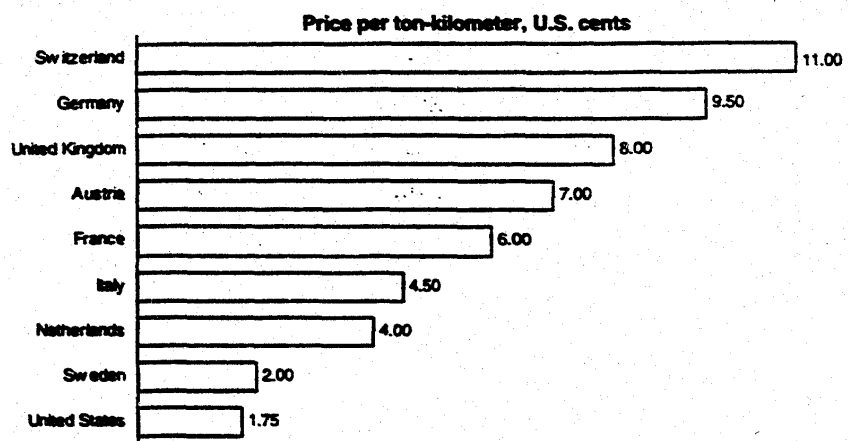
Source: Railroad Facts 1997, Association of American Railroads; Mercer analysis.

Figure 5
Annual Capital Expenditure as a Percentage of Revenues
for Various U.S. Industries
(1990-1995)

	1990	1991	1992	1993	1994	1995	Avg.
Manufacturing	N/A	N/A	3.5%	3.3%	3.4%	3.8%	3.5%
Consumer Durables	2.2%	2.4%	2.4%	2.1%	2.1%	2.1%	2.2%
Paper and Allied Products	8.6%	7.4%	6.2%	5.7%	5.6%	5.6%	6.5%
Pulp, Paper, and Paperboard Mills	16.7%	18.4%	14.1%	9.9%	6.5%	6.5%	12.4%
Petrochemicals	7.7%	7.9%	6.7%	6.3%	5.5%	4.5%	6.4%
Plastic Materials, Resins, Synthetic Rubber	7.8%	7.7%	5.4%	6.1%	6.8%	5.4%	6.5%
Petroleum Refining	2.4%	3.8%	4.5%	4.6%	4.3%	4.3%	3.9%
Steel Mills	5.1%	6.3%	4.6%	3.6%	4.6%	4.5%	4.7%
Automotive Parts and Accessories	5.3%	5.1%	4.3%	4.4%	4.3%	5.2%	4.8%
Computers and Peripherals	3.3%	3.2%	3.4%	3.2%	2.6%	2.3%	3.0%
Telecommunications Equipment	3.8%	3.0%	3.3%	3.4%	3.1%	3.5%	3.4%
Aircraft	2.0%	1.8%	2.6%	2.1%	1.7%	1.3%	1.9%
Missiles and Space Vehicles	2.6%	1.9%	1.6%	1.9%	2.1%	2.1%	2.1%
Aerospace	2.8%	2.6%	2.9%	2.3%	2.3%	2.1%	2.5%
Railroads	13.2%	12.8%	13.1%	14.9%	16.3%	19.1%	15.0%

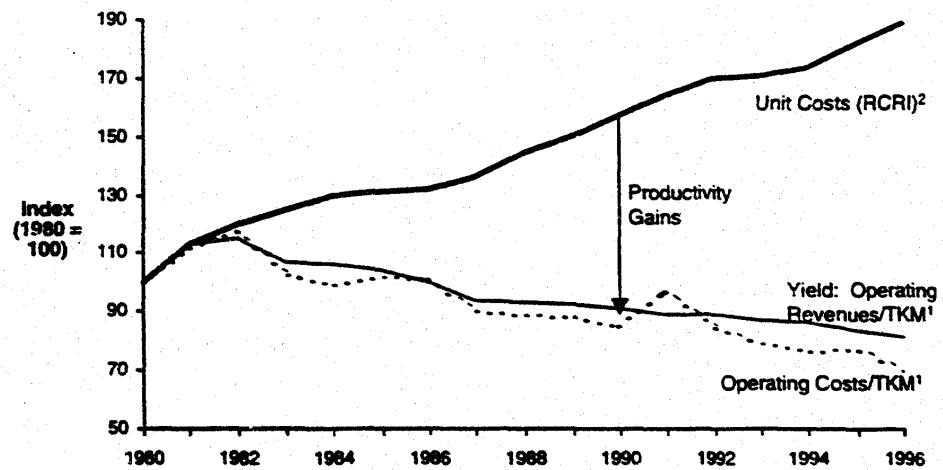
Sources: Statistical Abstract of the United States 1997, Railroad Facts 1997, American Association Railroads.

Figure 6
U.S. versus European Rail Freight Rates



Source: Statens Järnvägar Annual Report, referring to UIC statistics.

Figure 7
U.S. Rail Productivity Gains
(1980-1996)



Source: Railroad Facts 1997, Association of American Railroads; Mercer analysis.
¹Ton-kilometer.
²Railroad Cost Recovery Index.

Figure 8
Sources of Railroad Productivity

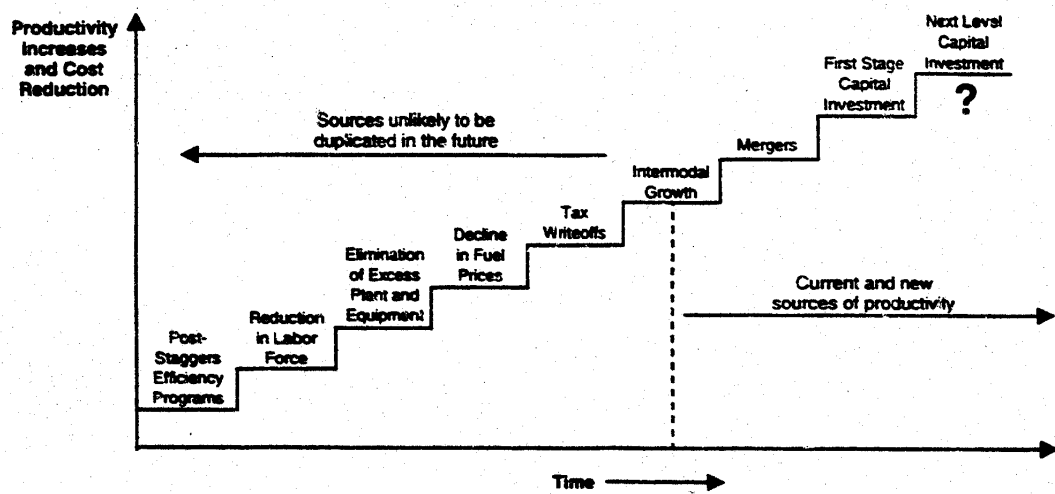


Figure 9
U.S. Railroad Profitability versus Cost of Capital

	Average			
	1979-1982	1983-1986	1987-1991	1992-1996
Return on investment (ROI)	3.3%	4.0%	5.4%	7.8%
Return on equity (ROE)	6.9%	6.5%	8.5%	10.0%
Railroad cost of capital	14.5%	14.1%	11.6%	11.7%

Note: These are simple averages of annual percent changes.

Source: Railroad Facts 1997, American Association of Railroads; Mercer analysis.

Section II

U.S. industries must compete increasingly in a global marketplace. The United States' highly competitive, low-cost rail transport network supports the international growth and competitiveness of U.S. industry. Furthermore, U.S. consumers benefit from the ready access to global markets that the U.S. rail network provides for containerized and bulk imports.

In recent years, the U.S. economy has been characterized by significant growth in international trade. Additionally, the North American Free Trade Agreement (NAFTA) has dramatically increased trade across the Canadian and Mexican borders. Efficient inland transport is critical to the growth of U.S. export trade, as well as to ensuring that U.S. consumers have access to a wide range of affordable imported goods.

- Exports as a percentage of GDP have increased from 7.2 percent in 1985 to 11.9 percent in 1997 (Figure 10). According to Standard and Poor's *DRI Transportation Review 1997*, "exports will be the fastest growing segment for many commodities" in the next ten years, "necessitating the ability to get goods to port." Additionally, "future buyers for U.S. goods will increasingly be overseas; in many industries, goods will have to be transported to ports and border crossings."
- In 1995, U.S. trade with Canada and Mexico accounted for 55 percent of all U.S. trade, amounting to \$379 billion dollars. Canada and Mexico are the first and third largest U.S. trading partners respectively (Figures 11 and 12).
- The United States is one of the leading exporters of bulk commodities. It originates 43.8 percent of world grain exports and 17.1 percent of world coal exports, making the United States the number one exporter of grain and the number two exporter of coal worldwide (Figures 13 and 14).

The United States's leading position in international trade is attributable in no small measure to our efficient, low-cost rail system. By providing U.S. exporters with low rail freight rates, U.S. railroads are an important factor in the competitiveness of U.S. bulk and containerized exports in the global marketplace.

- Average rail costs per ton-mile are considerably lower than truck costs per ton-mile: Class I rail revenue per ton-mile in 1995 was 2.5 cents compared to truck revenue per ton-mile of 25.1 cents.⁸

Railroads handle a significant amount of U.S. exports and imports.

- The U.S. Department of Agriculture estimates that 41 percent of grain exports in 1994-1995 moved to ports by rail.⁹ In 1996, 350,000 carloads of grain, valued at \$5 billion,

⁸ *Transportation in America, 1996*, Eno Transportation Foundation.

⁹ U.S. Department of Agriculture and American Association of Railroads.

were transported by rail to ports for export.¹⁰ According to the Department of Energy, 80 percent of coal moved to ports for export is transported by rail. Total U.S. coal exports have been valued at \$3.5 billion annually in recent years.¹¹

- According to the U.S. Department of Transportation, railroads carried goods valued at \$73 billion in our 1996 trade with Canada and Mexico. Railroads carried nearly \$21 billion worth of goods exported to Canada and Mexico and \$52 billion of goods imported from these two countries. The leading commodities moving by rail in trade with these countries are motor vehicles and parts (\$37.6 billion); paper, paperboard, and wood pulp (\$5.6 billion); chemicals and fertilizers (\$4.1 billion); wood and wooden articles (\$4.0 billion); and plastics (\$2.5 billion).¹²
- Railroads originated a total of 8.7 million trailers and containers in the United States in 1997 in intermodal service (which continues to be the fastest growing segment of rail traffic – up 40 percent since 1990). An estimated 34 percent of this traffic is interlined with international steamship companies, representing about 3 million units with a value of \$120 billion moving in offshore international trade.¹³ This represents 35 percent of all liner imports and exports.¹⁴

The United States, unlike many other countries, is heavily dependent on rail for international trade. In Europe, by comparison, rail is a relatively insufficient factor in export and import traffic.

- In 1996, 26 percent of all freight tonnage, 40 percent of ton-miles and 12 percent of revenue moves by rail in the United States.¹⁵ Approximately 80 percent of coal and 41 percent of grain delivered to ports for export moves by rail. Approximately 35 percent of intermodal imports and exports moves to or from ports by rail.¹⁶
- On the other hand, rail represents only 17 percent of freight ton-miles in Western Europe.¹⁷ Intermodal exports and imports for Europe moving by rail have dropped from 28 percent in 1982 to only 19 percent (based on 1992 figures, the most recent available). This 47 percent drop in rail use shifted approximately 1.6 million additional TEUs annually onto European highways.¹⁸
- U.S. and European ports also differ widely with respect to their dependence on rail. For example, an estimated 75 percent of Tacoma's, 70 percent of Seattle's and 50

¹⁰ *Agricultural Statistics 1997. USDA and Grain Transportation Report.* USDA, March 2, 1998.

¹¹ American Association of Railroads (data supplied by U.S. Department of Energy).

¹² Transborder Surface Freight Data 1996. Department of Transportation Website (www.bts.gov), accessed 3/25/98.

¹³ American Association of Railroads.

¹⁴ *World Sea Trade Service Review*, Q4 1997, DRI McGraw-Hill/Mercer Management Consulting, Inc.

¹⁵ *Railroad Facts 1997*, American Association of Railroads.

¹⁶ *U.S. Railroads and International Trade*, American Association of Railroads.

¹⁷ *Transportation Statistics Annual Report 1997*, Chapter 10, U.S. Department of Transportation.

¹⁸ *Containers Inland 1994*, MDS Transmodal.

percent of Los Angeles' and Long Beach's port container traffic moves by rail.¹⁹ By contrast, containers move to and from the Port of Rotterdam (Europe's largest container port) predominantly by truck (41 percent of tons), while rail represents only 11 percent of container traffic to and from the Port (remaining 48 percent moves by barge and short-sea feeder).²⁰ Similarly, even though the Port of Antwerp is the terminus of 12 international railway links, only 33 percent of imports (22 percent of containers) and 17 percent of exports (13 percent of containers) leave and enter Antwerp by rail.²¹

Since rail is a minor factor in terms of European international trade, but an important component for U.S. trade, it is easier for Europe to experiment with different access regimes without running the risk of disrupting the infrastructure that plays a key role in supporting international trade.

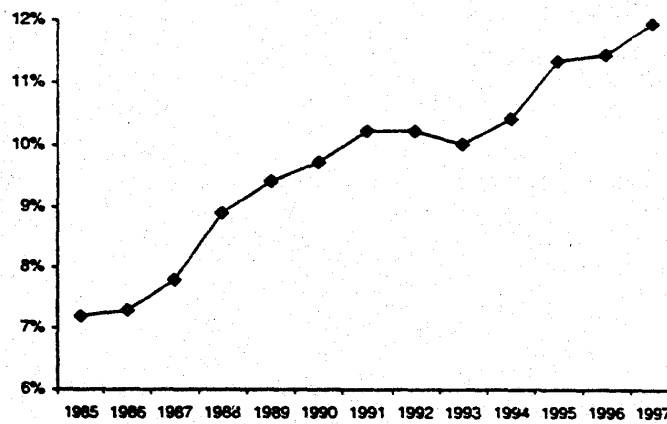
In summary, we believe that the burdens placed on the U.S. rail system due to the implementation of a system of open access would ultimately reduce U.S. exports, drive rail traffic onto highways, and increase the price of imports to U.S. consumers. Why? Because as we demonstrate later in our statement, the experience of countries that have adopted open access regimes strongly suggests that U.S. railroads would be crippled in 1) their ability to raise capital in the private sector for infrastructure investment, and 2) their ability to engage in differential (Ramsey) pricing. Private capital investment and differential pricing are two of the fundamental cornerstones of post-Staggers public policy in the United States and critical to the strength of the U.S. rail network. If they are threatened, as they would be if open access were adopted, the favorable position of the United States in international trade would also be put at risk.

¹⁹ Mercer analysis (1996 estimates).

²⁰ Port of Rotterdam Website (www.portrotterdam.nl), accessed 3/17/98.

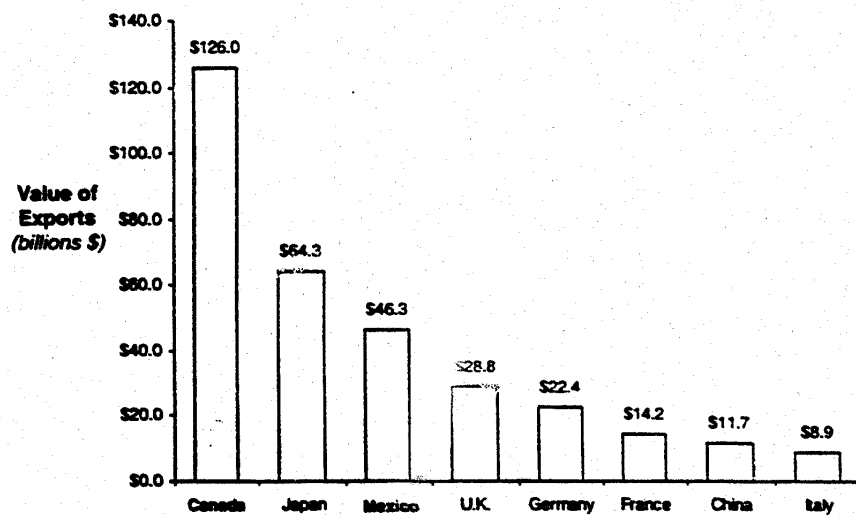
²¹ Port of Antwerp Website (www.portofantwerp.be), accessed 3/17/98.

Figure 10
U.S. Exports as a Percentage of GDP
(1985-1997)



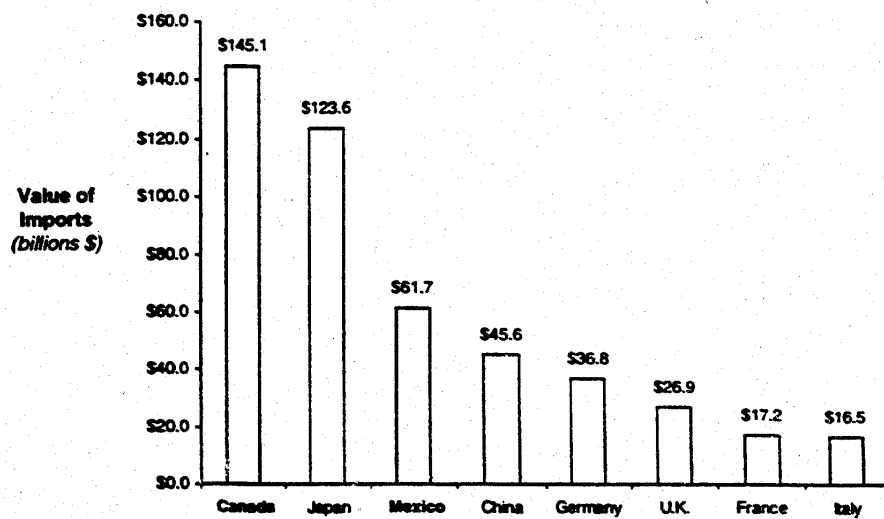
Source: Economic Indicators, Jan. 1998, Statistical Abstract of the United States, 1996.

Figure 11
Leading Destinations for U.S. Exports
(1995)



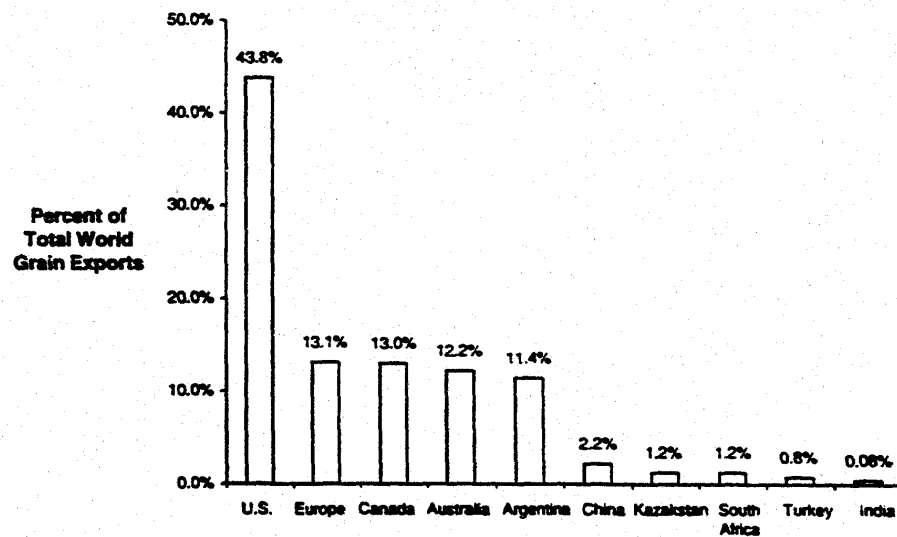
Source: Statistical Abstract of the United States, 1996.

Figure 12
Leading Origins for U.S. Imports
(1995)



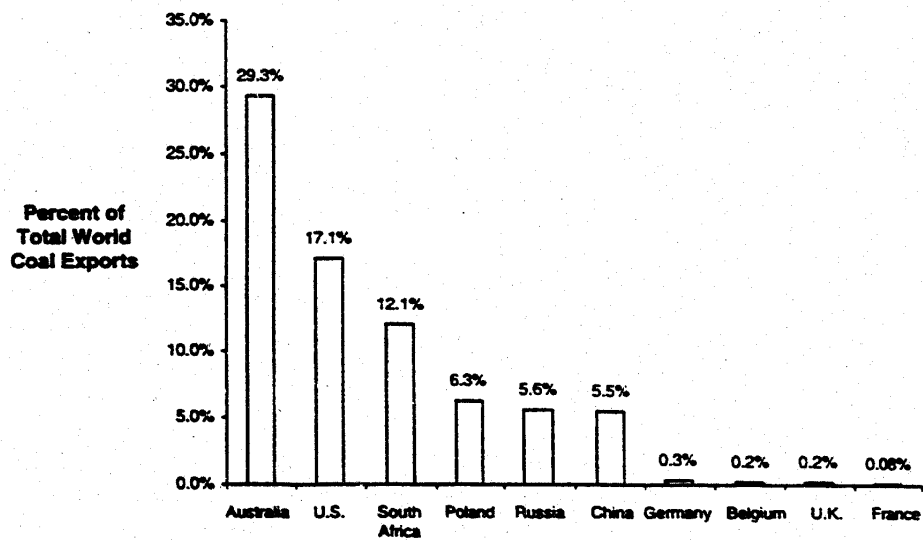
Source: Statistical Abstract of the United States, 1996.

Figure 13
Top 10 Leading Exporters of World Grain¹
 (1996)



Source: U.S. Department of Agriculture, World Grain Markets and Trade, February 1998.
¹Includes wheat, corn, barley, and sorghum.

Figure 14
Top 10 Leading Exporters of World Coal¹
(1996)



Source: International Energy Agency, Coal Information 1996.
¹Includes hard coal, coke, and steam coal exports.

Section III

Forced access has been considered, but rejected, by many countries as a model for restructuring their rail systems.

As we noted in the introduction, Mercer has assisted many countries throughout the world in developing their rail restructuring programs. The authors of this statement have been involved personally in most of these assignments, and therefore have firsthand knowledge of the strategic choices faced by public decision makers trying to revitalize underperforming rail networks. Two countries in particular – Argentina and Mexico – are especially instructive, because in each case, the national governments debated whether to adopt a vertical integration or open access model of rail restructuring. In each case, open access was rejected for reasons discussed below.²²

Background

In the late 1980s and early 1990s, many countries, primarily in Central and South America, found their rail systems in a state of near collapse. Other countries, such as those in Western Europe, experienced a situation where the subsidies needed to continue domestic rail operations and provide an acceptable level of capital expenditure were becoming politically unsupportable. Like the United States in the 1970s, rail reform became a political and economic imperative.

At the beginning of the process in several of these countries, two very distinct structural models, each with unique and opposing characteristics, emerged as basic platforms for reform: vertical integration on the one hand, and mandated open access on the other.

- **Vertical integration:** A vertically integrated railroad controls both access to its track and operations over its network. In most cases, access to the railroad's network by others is commercially negotiated. In a few cases, limited levels of access may be mandated by the regulatory authority for specific parties on selected routes where it is deemed necessary to complete a logical network or route structure.
- **Open access:** Under open access regimes, multiple operators are permitted to provide service over most or all of the network. Infrastructure is separated from operations, with the infrastructure usually managed as a regulated monopoly by a separate organization. The operating companies contract for access with the owner of the track. If a vertically integrated railroad already exists, the government forces it to open its track and facilities to alternative operators. Although extensively discussed by policy-makers and frequently cited as pro-competitive, there are few examples of open access actually being put in place in the railroad industry. In point of fact, open access with respect to railroad operation exists today primarily as a theory, not as an actual mode of operations. Where it actually has been implemented, e.g., the United Kingdom and Australia, aspirations for increased competition have yet to be realized and subsidies

²² The Japanese and New Zealand governments also chose vertical integration as the method for restructuring their rail systems in the late 1980s. See *Best Methods of Railway Restructuring and Privatization*, Ron Kopicki and Louis Thompson, Cofinancing and Financial Advisory Services (Privatization Group), The World Bank, August 1995.

remain. Concurrently, there have been continuing issues of commercial complexity and the perpetuation of extensive regulation.

Two case studies of countries that have successfully restructured their railways as vertically integrated businesses are presented below.

Argentina

Prior to 1993, Argentina's state-owned Ferrocarriles Argentinos (FA) Railroad provided all freight, passenger, and commuter rail services throughout the country. In 1993, FA subsidies cost the Government of Argentina \$1.3 billion (1 percent of GDP), and the subsidy cost was rising. The railroad had less than 10 percent share of the freight market and less than 6 percent share of the intercity passenger market. Faced with a lack of investment in the transport system, poor service quality, increasing competition from other modes, and massive subsidies, the government decided that fundamental restructuring of FA must be undertaken immediately.

Initially, there was considerable expression of interest within the government for adopting an open-access regime for the Argentine rail network. The primary objectives of the government however, were to reduce the governmental subsidy burden and to promote private sector investment in the rail infrastructure. In order to determine whether the government could achieve its objectives within the framework of open access, Mercer conducted a series of informed dialogues and discussions with prospective bidders in the private sector to ascertain the likelihood that they would participate as bidders for the geographical freight and passenger rail concessions created by the Argentine government. In every case, the private sector response was that there would be no interest in bidding on a franchise and investing substantial amounts of capital where a competitor could appear at any time and attempt to appropriate the economic benefits of the concession. Furthermore, the prospective bidders noted that, unless operational and infrastructure investments were coordinated, many inefficiencies and disputes were likely to occur.

Based on this feedback, the Argentine government quickly decided that the concessioning of vertically integrated franchises was the proper, indeed the only, effective approach. Accordingly, the government separated freight service into six vertically integrated segments; five of the six segments were concessioned to private operators. Inter-city passenger services were transferred to the provinces, and commuter services were concessioned to private operators as seven vertically integrated businesses.

The freight concessions mandated track access for intercity passenger operations, and the commuter concessions mandated track access for freight and intercity passenger operations. But no access was permitted for competing services by third parties within the franchises. Maximum freight rates were established in the concession agreements and indexed over time. Concessionaires were allowed to request an increase in maximum rates from a small regulatory body established to oversee the concessions. In practice, however, the rate ceiling has never been invoked because actual rates are substantially below the maximums allowed.

The restructuring has been a success in terms of deficit reduction and private sector investment. The separation of rail services into vertically integrated businesses made the concession process attractive to private investment. Despite the fact that, at the time, concessioning of government rail operations was a novel concept, each franchise received multiple concession bids, which provided the government leverage in negotiating target levels of private sector infrastructure investment. In some cases, the concessionaires are investing greater amounts in the infrastructure than required by their contracts and are providing higher levels of service in return for longer concession periods and greater flexibility in tariffs.

The vertically integrated restructuring of FA also allowed a self-supporting railroad industry to develop. Federal subsidies for freight concession services and intercity passenger services have been entirely eliminated, and the subsidy for subway and commuter services greatly reduced, from \$1.3 billion in 1993 (mostly in the form of operating payments) to only \$250 million (primarily for capital expenditures) in 1996.

Both railroad productivity and efficiency have increased as a result of the restructuring. Between 1993 and 1997:

- Annual commuter passenger car-kilometers increased from 95 million to 148 million (56 percent)
- Commuter passengers increased from 212 million to 456 million (115 percent)
- Freight volume increased from 11.1 million tons to 18.8 million tons (69 percent)
- Freight tons per employee increased from 353 to 3,760 (1,020 percent)
- The railway work force was reduced from over 100,000 employees to approximately 20,000, notwithstanding the increase in passenger and freight traffic.

Despite these extraordinary gains, Argentina's privatized system still faces challenges. Prior to privatization, rail freight market share had declined to such low levels that some of the rail freight concessions are still not profitable. Nevertheless, a bankrupt, run-down system has succeeded in attracting substantial private investor interest, while at the same time drastically reducing government subsidies and government regulatory oversight. The World Bank has stated that the Government of Argentina is "clearly enormously better off financially under the new system and [its] rail service has improved measurably."²³

Mexico

Ferrocarriles Nacionales de Mexico (FNM), a state-owned rail monopoly, provided all freight and intercity passenger rail services in Mexico prior to restructuring. In 1995, FNM lost 3.7

²³ *Best Methods of Railway Restructuring and Privatization*, Ron Kopicki and Louis Thompson, Cofinancing and Financial Advisory Services (Privatization Group), The World Bank, August 1995.

billion pesos²⁴ (approximately US\$460 million) and was suffering from low productivity, underperforming assets, and falling prices. Additionally, it was losing market share to truck. The Mexican government decided to restructure the railroad to promote private-sector operating efficiencies.

It was important to the government that the restructuring preserve economies of scale, attract private investment, and increase competition. After considering the possible options, it was Mercer's recommendation to concession FNM, segmenting it into three vertically integrated linehaul concessions, a Mexico City Terminal concession, and a number of light density line concessions. The regulatory regime was carefully designed to be market-based, with minimal government regulation and control, to ensure that concessions would be financially viable, generating sufficient income to attract investment.

Once again, Mercer test-marketed the idea of open access (the British model) to railroads, financial institutions, shippers, and other interested parties. Of all the options considered, this approach received the lowest ranking, because of the belief that it would diminish the value of the concession, thereby defeating the objectives of strong private sector participation and investment. Instead, the Mexican Government decided to emulate the U.S. model by establishing 50 year concessions in which the concessionaires are responsible both for above rail operations and track maintenance. As the FNM concessions are sold, the subsidy for freight service is being eliminated. Only selected intercity passenger services will be subsidized.

The Mexican restructuring experience has been an unqualified success in terms of deficit reduction and private sector investment.

- The first concession awarded – the 4,283 km Northeast Railway – had a net operating loss in 1994 of 5.4 million pesos (US\$675,000). In 1996, it was concessioned for US\$1.4 billion (for 80 percent of ownership interest), providing an implied 100 percent concession value of US\$1.75 billion.
- The second concession, the 7,464 km Pacific North Railway (which has significantly lighter traffic density than the Northeast Railway) sold last year for US\$525 million, also despite prior operating losses of as much as 55.2 million pesos in 1994 (US\$6.9 million).
- The concessionaires for the Northeast Railway (Transportacion Ferroviaria Mexicana) recently announced a US\$553 million, four-year infrastructure investment program. The company expects a compound annual growth rate of 15 percent over the next 3-5 years.²⁵
- Initial interest in the third mainline concession in the Southeast, to be bid this year, has been expressed by several consortia that include a wide range of private interests, including North and South American rail operators and steel and mining companies.

²⁴ All figures for pesos are given in inflation adjusted year-end 1995 pesos. Approximate exchange rate is 8 pesos=US\$1.

²⁵ "Top News: North and South America." *Railway Gazette*, March 1998.

The approach adopted by the Mexican Government vividly illustrates the capacity of vertical integration to protect franchise values and to match the needs of infrastructure investment to marketplace demand. Open access, on the other hand, tends to diminish franchise values and to promote misalignment between infrastructure investment and operational requirements.

Figure 15 charts the prices paid by buyers of vertically integrated rail systems in the United States, New Zealand, and Mexico between 1988 and 1997, compared to the price paid by the English, Welsh & Scottish Railway (EWS) consortium for the freight concession over the "open access" rail system in the U.K. As indicated:

- In every vertical integration case, the buyer has paid a multiple of more than 1 times the annual revenues produced by the system. In the case of the northeastern Mexico concession, the buyers paid an extraordinary premium of 7.7 times revenues, even though substantial investment was required.
- In the case of the EWS, the ratio paid was only 0.4 times revenues, just 30 to 40 percent of average U.S. values and a startling 5 percent of the value commanded by the Mexican system.
- TransRail paid 3.2 times revenues for the vertically integrated New Zealand franchise. It should be noted that the Wisconsin Central Railroad was a lead investor for both the TransRail consortium in New Zealand and the EWS consortium in the U.K. Wisconsin Central paid over 600 percent more for the vertically integrated New Zealand system than for the open access U.K. system. This is a very clear indication that private capital markets are willing to invest in vertically integrated systems, but are unwilling to do so in open access regimes, unless the capital commitment is minimal.

What caused such a large disparity in valuations? In our opinion, the explanation is relatively simple. In integrated systems, the owner is able to *measure* and *capture* the full economic value of the business unit it is acquiring. The owner can match capital outlays with customer demand and can garner the efficiencies which occur when operating decisions are coordinated with investment decisions. Moreover, without the threat of "cherry-picking" of high margin traffic by potential competitors, the owner can engage in differential, demand-based pricing. Just the opposite occurs in an open access regime. Thus, as the examples of Mexico, New Zealand, and the U.K. illustrate, vertical integration supports full economic value, while open access diminishes it.

If an open access regime was imposed in the United States, we can confidently predict that a large and dramatic downward valuation of railroad market values would occur, which in turn would have a devastating effect on railroad investment in infrastructure.

"Open" or "forced" access has been adopted in some countries as a means of creating seamless service across political boundaries, but to date it has been minimally implemented and has had limited success in increasing intra-rail competition, substantially reducing government subsidies to the rail network, or eliminating regulation. Three case studies are presented below.

Western Europe

Mercer maintains a large European transportation consultancy, with offices in Lisbon, London, Madrid, Munich, Paris, and Zurich. We are, therefore, familiar with the state of railroad reform in the region. We have also served as consultants to several European railroads, as well as to the European Commission with respect to the introduction of "rail freightways" to permit seamless, cross-border rail freight transport throughout Europe.

It is difficult to extract lessons from the European rail restructuring experience in relation to the United States because rail and political structures are so fundamentally different (see Figure 16).

The European rail system is:

- Balkanized; many non-integrated national systems
- Passenger dominated
- ROW owned by national governments
- Not an important factor in export/import traffic

By contrast, the U.S. rail system is:

- Seamless; comprehensive, established interchange protocols exist between carriers
- Freight dominated
- ROW owned by private sector
- Important factor in export/import traffic

Europe's rail network historically has consisted of a series of government-controlled, highly subsidized, passenger dominated national networks that for decades were focused on domestic social – as opposed to commercial – agendas, with little thought and less action given to transforming Europe into a unified entity that could collectively compete with the world's major industrialized trading blocks.

It is within this context that the European Union in 1991 issued its famous 91/440 Directive, which called on all member nations to separate track ownership from operations, and to allow free and open access to all would-be carriers of *international freight*²⁶ over the rail network within each member nation. Although Directive 91/440 mentions as one of its objectives the introduction of "competition" into the European freight and passenger system, we doubt whether any knowledgeable observer would quarrel with the proposition that the directive's primary

²⁶ Directive 91/440, Section V, specifically limits transit rights and access to "international groupings" or "railway undertakings" which provide "international combined transport goods services." It is not applicable to domestic traffic within a sovereign nation.

objective was to force each sovereign nation within the community to focus on ways to achieve efficient trans-European rail service. If each nation were required to give unfettered, non-prejudicial access to one another's rail networks, then perhaps a *modus vivendi* could evolve that would facilitate seamless rail transport throughout the region, without the extensive border exchange disputes, labor rule discrepancies, and equipment differentials that historically characterized most European rail traffic. The EU's objective, therefore, was to establish, by regulatory fiat, a system of interchange rules, commercial integration, and cooperation *which has already existed in the U.S. for more 100 years*. In other words, in the United States, private sector commercial necessity (and the Commerce Interstate clause of the Constitution) created a boundary-less system of rail access for customers which European shippers do not currently enjoy – but which the EU understands is critical to its mission of forming a commercial “union” of sovereign states.

Thus, if 91/440 – and the creation of “open access” regimes – is viewed from the perspective of trying to create a pan-European rail transport system, we think it is a step in the right direction. However, it is not clear that it will bring about greater intra-rail competition, reduce government subsidies, or downsize government regulatory bureaucracies. For example, since January 1, 1993 (the effective date of Directive 91/440), less than a handful of companies have been organized to take advantage of the Directive's mandate requiring open, non-discriminatory access to the national rail networks of EU member countries for the international transport of goods, and these companies consist merely of freight forwarders that combine packages of cross-border rail and truck hauling services for shippers. No consortia have emerged (except in the U.K.) that actually own and operate their own rolling stock on rail trackage owned by others.²⁷

While all EU members have separated infrastructure from operations as a matter of accounting, only the U.K. and Sweden have adopted a structure that creates a true separation of rail operation and track ownership, *and* (at least in principle) allows multiple operators to compete for rail freight service.

Once again, it bears repeating that despite references to competition, we believe the “open rail access” mandated by Directive 91/440 was *not* primarily intended to address a “captive shipper” problem. Rather, it was intended to improve the competitive position of rail versus other modes and to address a service problem of antiquated, inefficient rail interchange protocols among sovereign nations.²⁸ Indeed, the Directive's restriction of open access to “international” transport belies the notion that the EU desired unrestricted access by independent operators to any and all shippers.

²⁷ It was recently reported that a joint venture between UPS and Germany's postal service is planning to operate its own trains to deliver packages in trans-European service. If implemented, this would be the first new entrant into the international European rail freight business pursuant to Directive 91/440. (*Journal of Commerce*, March 19, 1998.)

²⁸ The Preamble to Directive 91/440 repeatedly refers to the need for “greater integration of the Community transport sector,” for operators to “behave in a common manner,” and other language that indicates that service integration was the EU's primary objective.

In contrast, U.S. shippers, in calling for open access, are concerned with the issue of rail pricing. Applying the European model of open access to the U.S. rail network would make no sense because that model was developed to deal with political integration, not pricing concerns. In addition, it would re-introduce a number of adverse consequences that have been removed from the U.S. rail system, i.e.:

- Undermining of rail franchise values and disincentives for infrastructure investment
- Re-introduction of extensive regulation and pricing oversight
- Operational disputes
- Constitutional compensation issues not applicable to nationally owned rail systems
- Potential need for government subsidization of under-funded infrastructure

The notion of open access potentially leading to the need for government subsidies is more than mere speculation. As shown in Figure 17, several European countries have deliberately chosen to set access rates to their infrastructure at a fraction of full cost recovery. This implicitly – and realistically – recognizes that third-party rail freight operators will have to be subsidized with respect to their contribution to infrastructure costs if open access is to succeed in attracting new entrants. An examination of the British Rail experience will illustrate these points.

United Kingdom

In 1991, British Rail (BR) received government subsidies of \$800 million and generated revenues of \$4.6 billion. Its freight market share was less than 10 percent and declining. Through restructuring, the government sought to reduce the subsidy, improve productivity and service, create innovation in the industry, and increase rail market share.

The government chose an "open access" scheme as it was thought that promoting competition would be the best way to reduce costs and improve service. Regulatory oversight would be used to prevent potential abuse by the owner of the infrastructure.

- BR was "unbundled" into 100 separate businesses to be sold individually to the private sector, including six freight businesses and 25 passenger train operating companies (TOCs).
- A separate infrastructure owner/manager, Railtrack, was created and floated on the Stock Exchange in 1996.
- An independent Regulator and Safety Inspectorate were created to promote competition and regulate abuse of monopoly power.

Access is managed by Railtrack and overseen by the Office of the Rail Regulator (ORR). Railtrack is responsible for operator licensing, provision of paths, and train control; the ORR regulates service and contractual compliance and approves access agreements. Access rates are charged on the basis of 100 percent cost recovery plus profit and based on ability-to-pay with

minimum equivalent to marginal cost. There are separate charges for each line section and traffic flow. Passenger services are subsidized by the Office of Passenger Rail Franchising (OPRAF). Freight services are not directly subsidized.

The complexity of the transaction and the daunting potential impact of intense intra-rail competition discouraged private participation and investment, reduced the number of bidders, and depressed the value of the rail freight franchise.

- As previously seen in Figure 15, the value bid by EWS was a fraction of the value normally commanded by integrated systems.
- Virtually no intra-rail freight competition has resulted from the transaction. A consortium led by Wisconsin Central acquired five of the six freight concessions. These were re-merged into the EWS.
- Bidding for the freight franchise was anemic. Two other railroads, Railroad Development Corp. (RDC) and Anacostia & Pacific had expressed interest in the U.K. freight businesses, but were deterred from bidding because the final structure chosen was both highly complex and (because of open access) potentially risky.²⁹
- In addition to the absence of real competition, the open access regime is highly complex and has increased government subsidy costs. In January 1997, it was revealed that although Railtrack was showing a profit, it had a backlog for spending on infrastructure of 330 million pounds (US\$213 million). The U.K. Rail Regulator called the company's spending levels "wholly unacceptable."³⁰ The U.K. is not the only country that has faced soaring subsidy costs since the separation of operations from track ownership. Figure 18 shows that when the Swedish Government unbundled operations and infrastructure, subsidies for track and ROW soared to over SK10 billion per year (US\$1.4 billion).

The results of open access in the U.K. have met with dismayed reactions. Chairman of the British Railways Board, John Welsby, recently stated that "an objective assessment of the performance of the privatised railway today shows that, in general, it is hardly better than it was in the last two years of public ownership. That is a great disappointment....The situation is particularly ominous because very significant additional public funds have now been injected into the industry."³¹ U.K. Franchising Director John O'Brien has also noted that "performance levels generally continue to concern and disappoint me."³²

²⁹ "U.S. Railways Seek Stake in BR freight," *The Financial Times*, September 11, 1995, page 8.

³⁰ "Rail Spending is Challenged," *The Financial Times*, USA Edition, January 18, 1997, page 4 (approximate exchange rate is US\$1.55 = £1).

³¹ "Welsby Asks the Crunch Questions," *Railway Gazette*, February 1998.

³² *Ibid.*

Australia

Mercer has been retained as consultants for over a dozen projects in the last five years involving the restructuring of the rail systems in the Australian states of New South Wales (NSW) and Queensland.

Nearly all railroads in Australia are government-owned, either by the states or the federal government (Australian National Rail). The few exceptions are private mineral-hauling railroads, primarily in the northwestern part of the state of Western Australia. Historically, interstate rail traffic in Australia has not been viable, for a number of reasons:

- Most railroads focused on intrastate business – investment in the interstate rail network had been woefully inadequate
- Government policies had significantly reduced costs of competing road hauliers (e.g., weight and load limits, taxation, road improvements)
- Network density was low

The Federal Government instituted a policy of "open access" for critical government infrastructure in the mid-1990s, in an effort to improve Australia's competitiveness. This open access policy applied not only to railroads, but to a variety of other industries, including power generation/transmission, water supply, and airports.

As in Europe, the individual Australian states have taken different paths in implementing the generic policy of open access, from a relatively simple internal financial change to allow calculation of infrastructure access fees, to complete separation of the railroad into access, infrastructure, and operating units. Those railroads that took the more extreme course typically did so with the objective of not only opening the network to new operators, but to enable the introduction of competition with respect to infrastructure improvements, which had historically been controlled by powerful unions. Thus, these railroads are using open access to facilitate the outsourcing of infrastructure maintenance, similar to the outsourcing implemented by many North American railroads over the past 15 to 20 years.

The demand for open access has been very limited thus far, and no new operators have appeared. Three organizations have contracted with existing state-owned railroads to operate dedicated trains in competition with National Rail, typically only one train per week.

- SCT, a ship container forwarder, for a train between Melbourne and Adelaide
- Two forwarders for service between Melbourne and Perth

These "new" services, however, are very similar to the "new" services in Europe that have arisen since Directive 91/440: they are simply freight forwarding operations that package existing rail services for their customers. They neither own nor operate any equipment, nor do they have any capital at risk.

Several organizations (including existing railroads) have considered competing with New South Wales' Freight Rail to handle coal, but to date, no one has actually done so, because potential operators have not been able to justify investment to enter the market. One shipper did decide to purchase its own rolling stock, but the volume fluctuations associated with export coal subsequently led that shipper to contract with Freight Rail to provide service. Additionally, several railroads have expressed interest in purchasing Freight Rail's coal network and above rail assets, but not in a fashion which would provide multi-carrier competition.

The results of open access thus far in Australia have not produced marked improvements:

- Much of the rail network was not viable prior to open access, and open access has not changed that situation.
- There have been significant additional costs to implement open access, most of which have been borne by the incumbent railroads (in effect increasing their cost structure). These costs have included increased internal organizational costs, loss of normal internal above/below rail coordination, and the establishment of large and costly internal bureaucracies (e.g., NSW has assigned more than 200 administrative personnel to process any potential applications – there have been none thus far – for access over the rail network by third-party operators).
- In addition, because existing state-owned railroads must demonstrate to potential new entrants that *their own* above-rail operations are "fair and equitable," each railroad has had to reduce all of the business interfaces and issues which previously were resolved through unified internal administration to a complex contractual agreement between its operations unit and infrastructure unit.

Lessons learned from case studies

The experience we have gained in observing and directly participating in rail restructurings has allowed us to reach certain firm conclusions regarding the appropriate approach for public policy makers to adopt with respect to the concept of "open" or "forced" access versus vertical integration:

- Investment in infrastructure is more responsive to market realities when it is an integral part of the rail service package. Infrastructure investment can be much more closely matched to service levels in an integrated model.
- Integration of infrastructure and operations enables a railroad to maintain the value of the railway franchise and attract sufficient capital to maintain assets. Open access may require government investment because of diminished private sector interest.
- Railroads are complex operations with high fixed costs, thus requiring substantial economies of scope and density to be economically viable. Vertical integration ensures that economically efficient densities are retained, helping rail maintain its competitiveness with truck.

- Despite the stated desire to promote competition, existing open access regimes are dominated by single operators.
- Differential pricing, which is critical to the success of many businesses, particularly railroads (see Rockey statement, Section IX), is undermined by open access.

The World Bank agrees with many of these observations. In its review of a number of large international railway restructuring projects, including Japan, New Zealand, the U.K., and Sweden, the World Bank has stated that even where a railroad "enjoys effective monopoly power," the solution of allowing multiple operators to compete on the same track is counterproductive:

"The costs of operating coordination and the inevitable operating conflicts which arise as the number of distinct services increases over a single line cancel out the economic gains realized through managed competition. In addition, it is well established in railway economics that pricing based on elasticity of demand ("Ramsey Pricing") is the *only economically efficient way to recover fixed costs without external subsidy*. Competition over a line, when it causes rates to fall significantly on otherwise profitable commodities, may undermine the economic viability of the line" (emphasis added).³³

³³ *Best Methods of Railway Restructuring and Privatization*, Ron Kopicki and Louis Thompson, Cofinancing and Financial Advisory Services (Privatization Group), The World Bank, August 1995, page 319.

Figure 15
Representative Railroad Transactions
(1988-1997)

Transaction	Year	Route Miles	GTMs (billions)	Revenues (millions)	Density		Price		
					GTMs (mil/mile)	Revenues (000/mile)	Total (millions)	Per Mile (000s)	Price to Rev. Ratio
UP/MKT	1988	3,100	18.3	\$241.0	5.9	\$77.7	\$286.0	\$92.3	1.2
Prosp/IC	1989	3,000	36.1	\$500.0	12	\$166.7	\$554.0	\$184.7	1.1
UP/CNW	1995	5,211	72.1	\$1,100.0	13.8	\$211.1	\$2,828.1	\$542.7	2.6
UP/SP	1996	13,715	269.9	\$2,941.5	19.7	\$214.5	\$5,400.0	\$393.7	1.8
BN/SF	1995	8,352	222.2	\$2,789.1	26.6	\$333.9	\$5,200.0	\$622.6	1.9
CSX-NS/CR ¹	1997	10,701	212.2	\$3,586.5	19.8	\$335.2	\$10,700.0	\$999.9	3.0
TFM/FNM (NE)	1997	2,439	22.3	\$226.7	9.1	\$92.9	\$1,750.0	\$717.5	7.7
EWS/UK	1996	9,600	4.4	\$865.0	0.5	\$90.1	\$350.0	\$36.5	0.4
TranzRail/NZ	1993	2,463	3.0	\$141.2	1.2	\$57.3	\$452.4	\$183.7	3.2

Source: Mercer analysis.

¹Pending.

Figure 16
U.S. and European Railroads Compared
(1995)

	U.S. Class I ¹	British Rail ²	Other Major European ⁴	Major East European ⁵
Freight revenue	\$32.3 billion	\$924 million	\$11.3 billion	\$2.3 billion
Route miles	108,264	9,600	72,340	25,940
Employees	188,000	106,748	786,043	413,753
Freight cars	583,486	14,210	467,313	208,945
Freight ton-miles	1.3 trillion	6.9 billion	105.3 billion	55.8 billion
Passenger miles	5.8 billion ³	17.8 billion	138.4 billion	21.8 billion

Source: Rail Business Report 1996, Public Contributions to Railway Finances 1997 Study.

¹All U.S. data except passenger-miles excludes Amtrak.

²Passenger-miles data is for Amtrak.

³All British Rail data is for 1994.

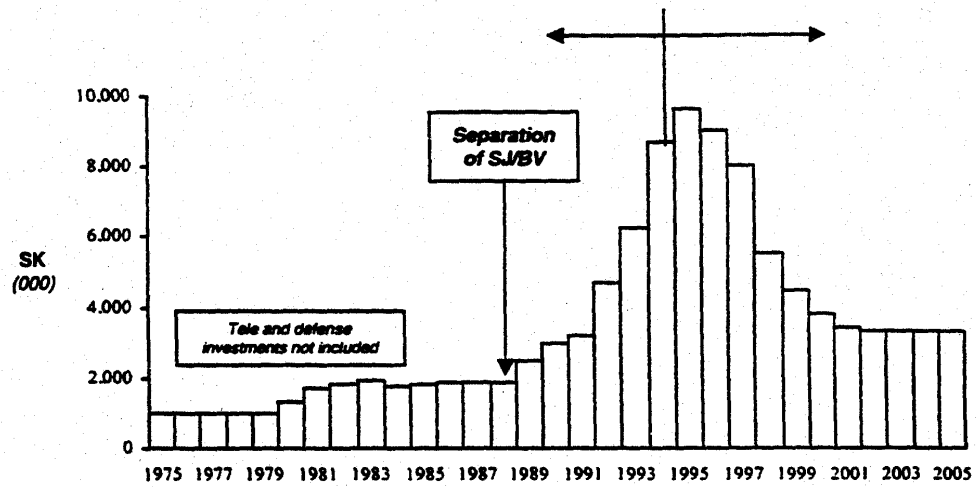
⁴Major European railroads included are DB, OBB, SNCF, DSB, SNCB, NS, FS, SJ, CP.

⁵Major East European railroads included are PKP, CSO, MAV.

Figure 17
Comparison of European Countries' Access Regimes

	France	Germany	UK	Italy	Sweden
Level	-30% cost recovery	100% cost recovery	100% cost plus profit	-30% cost recovery	-15% cost recovery
Basis	Ability-to-pay by business unit	Cost-based with some variation by train type	Ability-to-pay with minimum equivalent to marginal cost	Cost-based	Cost-based
Mechanism - Tariff or Negotiated - Disaggregation	Tariff Five networks	Tariff 1,200 sections	Negotiated Thousands of line sections, hundreds of flows	Tariff Main versus secondary lines	Tariff By vehicle type and facilities used
Scarcity Pricing	None	Auction to resolve conflicts	By negotiation	None	None
Penalties/Incentives	None	None	Punctuality, environment (intermodal)	None	None

Figure 18
Swedish Rail Infrastructure Investments
(1975-2005)



Source: Mercer analysis.

Section IV

Forced access would likely result in protracted litigation, severe railroad system dislocations, and the need for a large bureaucracy to administer complex regulations. Government subsidies would likely be required as well.

Litigation and disputes

If railroads were forced to offer access to independent parties, they would presumably demand and be entitled to receive full economic compensation (FEC) for the facilities and services provided. FEC not only includes the variable costs associated with operational support (switching, scheduling, yard operations, etc.) but also a fair share of fixed costs associated with the acquisition, maintenance, and replacement of right of way assets (land, ties, track, ballast, signaling, etc.). FEC could also include opportunity costs associated with lost traffic, contribution to profit, and other such costs. Determining FEC is not only extraordinarily complex, but also subject to the interpretation of many variables and inputs. This would inevitably produce contentious disputes between railroads and third-party operators, spawning a large dispute resolution bureaucracy. Access agreements in themselves are an onerous part of forced access, as thousands of new relationships between parties that were once integrated must be defined and costed out (e.g., in U.K. access agreements, even the use of washing and dressing rooms by different crews was provided for).

This prediction is not the product of doomsday thinking or the search for worst-case scenarios. Rather, it is a realistic assessment amply illustrated by cases where railroads have disputed the proper amount of compensation to be paid for granting operating rights over their facilities to third parties:

- For example, in August 1993, Conrail petitioned the ICC to establish the appropriate compensation that Amtrak should pay to Conrail for the incremental cost that Conrail incurred as a result of Amtrak passenger service over approximately 1,600 miles of Conrail track in the northeast United States (see Finance Docket No. 32467, Dec. 29, 1995). The major incremental cost was the cost of maintaining rail, ties, ballast, and other track materials, i.e., maintenance of way (MOW) cost. The ICC asked the parties to reach a negotiated solution. After 10 months, the negotiations were stalled. The ICC then initiated a proceeding, Finance Docket 32467, to gather evidence and adjudicated the issue.
 - At the start of the proceedings, each party proposed formulas that it suggested were the appropriate methodology for the ICC to use in computing the MOW cost caused by Amtrak trains on Conrail tracks. A total of *nine* separate formulas were proposed, which produced average costs per train-mile ranging from \$0.36 to \$2.55, a difference of more than 800 percent. (It thus became clear why the parties were unable to reach a negotiated solution.)
 - It took nearly two more years of hearings, expert testimony, pleadings, rebuttals, counter-rebuttals, and sur-rebuttals before the ICC reached its final decision. In rendering its decision, the ICC alluded to the tremendous difficulty of finding a

logical solution to such a highly complex issue. It noted that "no formula or methodology can perfectly determine how much different types of traffic contribute incrementally to track maintenance costs" (page 8). Even after finally deciding the issue, the ICC lamented that its decision was not a uniform precedent, but simply a one-time fix of an issue that was likely to recur unless the parties could negotiate a more permanent solution: "We caution the parties that acceptance of the model here does not imply that it will be accepted in future cases [because] the WSAC model is extremely difficult to follow and needs revision" (page 21).

Thus, this case study in adjudicated price setting illustrates all the perils which open access would unleash on the U.S. rail system were it to be implemented: complicated, lengthy, contentious legal proceedings; complex, ambiguous pricing formulas; and temporary, ephemeral results – in addition to the need for vastly increased regulatory resources to administer the proceedings and arbitrate the results.

Another example of this phenomenon – that forced access produces lengthy and complex disputes – is evidenced by the ICC order issued in 1982 requiring the UP to grant trackage rights to the SP over its main line from Kansas City to St. Louis. Once again, the dispute between the parties centered on the proper compensation to be paid by the SP to the UP. In this case, the dispute was not resolved for nine years. Between 1982 and 1991, the ICC had to issue four separate decisions, undergo numerous judicial appeals, and issue multiple clarifications before the matter was finally put to rest.³⁴

These cases illustrate a fundamental problem that proponents of forced access often overlook (or choose to ignore): The railroad right-of-way in the United States is owned by private parties, not by the Federal Government. This property cannot be appropriated against the will of the owner without adequate compensation. The imposition of any kind of forced access over U.S. railways by third-party operators would most likely produce a maelstrom of litigation and other legal action, thus probably delaying actual implementation by many years.

Absence of real competition

There is little evidence that forced access produces true, multi-operator competition. The U.K. experience is instructive. Prior to restructuring, the British Government anticipated that open access would produce extensive competition, e.g., that of the 12,000 track-miles carrying trainloads of aggregates, coal, petroleum, and steel, at least half would carry trains operated by more than one company and more than 25 percent would carry trains operated by more than three companies.³⁵ In fact, open access discouraged robust bidding for the rail freight franchises. The Chairman of one of the potential bidders, Railway Development Corporation

³⁴ ICC Finance Docket 30,000 (Sub-No. 8, 16, and 25).

³⁵ "Rail Freight Privatization: The Government's Proposals," British Department of Transport, May 1993.

(which subsequently declined to participate), was quoted as saying, "The U.K. has chosen by far the most difficult railway environment I have ever seen."³⁶

The end result was that British Rail received only two bids, and the winning bidder, Wisconsin Central, was only interested in proceeding if it faced no intra-rail competition. A consortium led by Wisconsin Central ultimately absorbed five of the six rail freight franchises, accounting for virtually all major freight movements in the U.K.³⁷ As Edward Burkhardt, CEO of Wisconsin Central, noted, "A flowering of competition is not yet among the notable successes of the British rail industry."³⁸

The British experience is mirrored by the course of events in New South Wales, Australia, where no operators have chosen to challenge Freight Rail, the existing state-owned railway, even though open access has been mandated by law.

In our experience, the dearth of new entrants in these situations is not surprising, because the barriers to entry are high. Even if an appropriate pricing structure can be agreed upon, the new entrant must negotiate contracts with shippers, assemble rolling stock and personnel, and construct a business plan that can be sold to the capital markets. We believe the last point to be the ultimate hurdle. In our practice, we advise commercial and investment banks on an almost daily basis. These banks simply are not willing to commit capital to rail operations where potential profit can be competed away by other new entrants. Thus, even the *threat* of additional competition scares off investment capital. Indeed, even before EWS was able to obtain financing for new locomotives, its lenders had to be assured that EWS had essentially secured a dominant, if not monopoly, position in the U.K.

Bureaucracy and transaction costs

We have already noted that in New South Wales, the state-owned railway established an open access administrative group of approximately 200 people to handle *potential* applicants for operating rights over the NSW system. But it is not just the existing operating railroads that have had to expand their work forces to deal with open access issues. Government and regulatory bodies must respond as well. For example, the following scene occurred recently in the U.K. (as reported in *Modern Railways*):

When ScotRail (one of the new passenger franchises) wanted to implement long-standing plans to step up the Edinburgh to Glasgow service from two to four trains an hour, a meeting of 45 senior people, including Rail Regulator John Swift, QC, spent

³⁶ Henry Posner, quoted in "US Railways Seek Stake in BR Freight," *The Financial Times*, September 11, 1995, page 8.

³⁷ Freightliner, which is restricted to carrying marine containers over discrete routes, was purchased by another consortium.

³⁸ "Competitive Access: Lessons from Great Britain," F. Wilner, *Journal of Transportation Law, Logistics, and Policy*, page 10.

the whole day on 3 August in an unsuccessful attempt to decide – in essence – whether they could, or could not, depart at precisely 15-minute intervals.³⁹

The World Bank has commented on the complexity of the U.K. system, noting that its implementation required “a mountain of legal documentation....Scaling this mountain has been described as the largest single legal task ever undertaken in the whole history of British commercial law.”⁴⁰

Since forced access is bound to quite dramatically increase disagreement and disputes over pricing and operational issues, we believe that it is inevitable that the existing regulatory bureaucracy would have to expand in kind to resolve these disputes.

Government subsidization

Mandated compensation, as opposed to market-driven, negotiated rates, will inevitably result in misallocation of resources and an economic windfall either for the infrastructure owner or the third-party operator. For example, in the U.K., Railtrack (the infrastructure company) has had a huge stock price run up; the market views it as a “money machine.” But there is no self-executing mechanism for assuring that revenue allocation will be fairly balanced between the operator and owner, or that infrastructure investments will be coordinated with operational needs.

- If revenue allocation is tilted toward the infrastructure owner, third-party operators will eventually exit from the business, producing uncertainty and confusion for customers. The operators will then have two choices: Either change the balance of compensation by litigation or legislation, or seek financial support from government sources.
- If revenue allocation favors the above-rail operator, the infrastructure owner will be deprived of investment capital. If insufficient private investment is available, pressure will be put on the government to make up the shortfall.

As previously noted, the World Bank has observed this phenomenon in Sweden, where ownership of infrastructure was segregated from above-rail operations. Figure 18 demonstrates the explosion in rail infrastructure spending by the Government after the repeal of vertical integration. As noted by the World Bank: “To date, no effective governance procedures have been developed in Sweden to assure efficient, balanced, productive investment in rail infrastructure.”⁴¹

³⁹ *Modern Railways*, October 1995, page 597.

⁴⁰ *Best Methods of Railway Restructuring and Privatization*, Ron Kopicki and Louis Thompson, The World Bank, August 1995, page 233.

⁴¹ *Ibid.*, page 201.

This theme is echoed by the EWS in the U.K.: "With separation of track control from train operations, I can't call my chief engineer, and say he must build this or that, and I can't engineer the right-of-way for the characteristics of the freight we carry."⁴²

The lesson is clear: The separation of ownership from operations is problematic, at best, with respect to revenue allocation and coordination of investment. Who picks up the tab if investment resources are misaligned? In the U.K., it is the taxpayer. Although government subsidies were *predicted* to decline substantially as a result of open access and privatization, thus far this does not appear to be the case. The subsidy of approximately 1 billion pounds received by British Rail between 1993 and 1994 rose to 2.1 billion pounds in 1994-1996, and is expected to settle at 1.9 billion pounds for 1997-1998.⁴³

We do not believe that it is unreasonable to suggest that, given the investment disincentives imposed by open access, and the resource misallocations experienced in the U.K. and Sweden, the U.S. taxpayer is at risk for subsidization contributions if open access should be implemented in the United States.

Revenue siphoning and devaluation of rail franchises

Historical experience demonstrates that where open access to existing rail infrastructure is allowed, new entrants will seek to "cherry pick" the most profitable business, leaving the railroad with lower-margin customers, lower profits, and less capital investment. For example, the threat of "cherry picking" produced bids of only 40 percent of revenue by prospective franchises in the U.K., whereas in Mexico, even though rail is much less competitive against other modes than in the U.K., franchisees bid up to 150 percent of revenue for the right to operate the concession. In New Zealand, the price/revenue ratio was 3.2 to 1.0.

The threat of "cherry-picking" is just another way of describing the demise of differential pricing. Open access directly invites new entrants to target an existing operator's most profitable traffic. Would U.S. airlines be profitable if new entrants, using incumbents' equipment, were allowed to capture the high-priced business customer? We don't believe so. And in the case of open access, U.S. railroads would suffer from similar siphoning of high-margin business.

Risk to capital investment

All of the inevitable effects of forced access – litigation, re-regulation, system dislocations, fragmentation, loss of economies of scale, cherry-picking – would produce one ultimate result: It would discourage the massive, private sector capital investment required over the next decade to sustain railroad gains in productivity. Railroads have exhausted traditional means of increasing productivity and sustaining profits, e.g., labor reductions, system rationalization, and differential pricing. New equipment and technology is vital to sustain a healthy U.S. rail system.

⁴² Edward Burkhardt, CEO of Wisconsin Central, quoted in Wilner, page 8.

⁴³ British Department of Transport Press Notice, "Transport Secretary Announces Forward Spending Plans," November 28, 1995.

Conclusion

In summary, based on our experience in other countries, we have grave reservations about the wisdom of applying forced access to the market-based operating environment of the U.S. railroad system. It is not in the national interest to roll back the clock to a pre-Staggers Act system of regulatory intrusion into an environment that, we believe, has struck a fair balance between U.S. railroads and their employees, shareholders, and customers. Forced access, if adopted, would result in a radical restructuring of the existing environment, without any compelling evidence from the experience in foreign countries – indeed in the face of substantial evidence to the contrary – that any net benefits would result.

Appendix A. Qualifications and Experience of William J. Rennie and Allan E. Kaulbach

Selected Worldwide Restructuring and Privatization Experience

Railway	Client Objectives	Status
FNM - Ferrocarriles Nacionales de Mexico	Privatize operations under multiple concessions to achieve commercial viability, establish access arrangements, assist in drafting restructuring law	Sale of first two concessions for more than \$2 billion
Buenos Aires commuter rail and subway; Argentine national rail system	Privatize passenger rail operations in Buenos Aires under multiple concessions; establish access arrangements, assist in drafting privatization/restructuring legislation for national passenger and freight rail service	Commuter rail and subway systems successfully concessioned; legislation passed
EFE - Empresa de los Ferrocarriles del Estado (Chile)	Privatize freight operations and equipment; open access regime established by law	Freight service successfully privatized but only one bidder stayed in process
Grand Trunk Western (U.S.)	Spin off Central Vermont Railway	Transaction completed with sale to subsidiary of RailTex (U.S. holding company for regional railroads)
Long Island Rail Road (U.S.)	Consolidate and privatize freight operations to achieve commercial viability under concession arrangement	Transaction completed with concession to a subsidiary of Anacostia and Pacific Corporation
New Zealand Rail	Due diligence to evaluate railway operations and finances in support of privatization	Transaction completed with sale to Wisconsin Central (U.S. regional railroad)
Hungarian State Railway (MAV)	Restructure organization, operations, and governance and identify legal/regulatory changes to commercialize state-owned railway	Mercer restructuring plan accepted
Polish State Railways (PKP)	Restructure organization, operations, and governance and identify legal/regulatory changes to commercialize state-owned railway	Mercer restructuring plan accepted; currently implementing
Czech Railways (CD)	Restructure organization, operations, and governance and identify legal/regulatory changes to commercialize state-owned railway	Mercer restructuring plan accepted

Railway	Client Objectives	Status
State Rail Authority (SRA) of New South Wales	Strategic review of SRA: benchmarking, restructuring, governance structure	Mercer recommendations accepted, restructuring underway
British Rail (BR)	Examine restructuring options and likely economic impacts of open access mandates on BR	Work completed; analysis used in responding to access mandates
Amtrak (U.S.)	Restructure organization into strategic business units and conduct network analysis to achieve self-sufficiency goals	Business design accepted and implemented with Mercer assistance; ongoing performance improvement work
Gabon State Railway	Privatize Gabon railway	Final evaluation of two remaining bidders
Angola State Railway	Reopen Malange Corridor	Private-public relationship developed
Queensland Rail, Queensland Depts. of Transport and Finance (Australia)	Strategic review of railway competitive access regimes worldwide and development of a business design for Queensland Rail to meet government's commercial objectives	Business design accepted, restructuring underway to meet commercial objectives
South Africa Rail Commuter Corporation (SARCC)	Develop concession structure and facilitate negotiations for contract; develop demonstration project concession for a private sector operator	Development of concession structures and demonstration project underway

William J. Rennie

Mr. Rennie, a Vice President in Mercer Management Consulting's Transportation Group, is responsible for Mercer's worldwide surface transport practice. He specializes in transportation strategic planning, management, marketing, economics, and operations, and has particular expertise in restructuring and organizational redesign to improve financial and operating performance of railways around the world.

Mr. Rennie's railway career spans three decades, including senior management and operating positions at Class I railways. He has been in the forefront of railway restructuring activities for both private and government-owned railways, and has also managed the development of many strategic and financial planning, simulation, and control models for railways. He has worked with senior management, boards of directors, and senior government officials on numerous rail restructuring, privatization, and commercialization projects carried out by Mercer. His recent experience includes the following:

- For Amtrak, the U.S. national passenger system, Mr. Rennie assisted the chairman, the board of directors, and senior management teams in designing a long-term strategic plan for restructuring Amtrak into strategic business units to improve operating and financial performance. He has served as a senior advisor in all aspects of Amtrak's restructuring program.
- Mr. Rennie served as a senior advisor to one of the seven largest North American Class I railroads in its attempt to acquire another Class I railroad. He assisted senior management of the railroad and an international investment bank in the valuation of the acquisition target and in structuring the transaction.
- Working closely with officials from the Hungarian Ministry of Transport, Communications, and Water Management, with senior railroad officers, and with World Bank representatives, Mr. Rennie directed Phases I and II of the development of a business plan for the Hungarian National Railway (MAV). The Phase I study outlined six strategic options that could lead to the long-term restructuring of the railway. The study also provided the foundation for developing a commercial approach to the conduct of the railway's business, establishing a wide range of relationships between MAV, the federal government, and other public agencies in Hungary. Internal and external benchmarking provided attainable goals in terms of the best practices of European and North American railroads.

In Phase II, he directed Mercer's development of the business plan and detailed organizational design for the option selected to establish a commercial, market-based structure for MAV. Phase II also involved development of the business plan for a restructuring agency established to manage non-commercial assets, resources, and services not included in the new railway.

Mercer Management Consulting, Inc.

- In a project funded by the U.S. Trade and Development Program, he directed the restructuring study for the Polish State Railways (PKP), the largest state-owned enterprise in Poland. Mercer developed a new strategy for freight and passenger services that will enable the railroad to reduce government operating subsidies. One of the project's cornerstones is a railway financial planning, control, and simulation computer model that Mercer constructed and customized for PKP's use. Mercer also conducted a comprehensive analysis of PKP's operations and operating environment, including an examination of the Polish economy and the rapidly evolving European transport market.
- Mr. Rennie directed Mercer's extensive participation in the Government of Argentina's program of privatization and commercialization of state-owned enterprises. Mercer evaluated Ferrocarriles Argentinos for a large international bank considering a debt-equity swap, and subsequently has assisted the Government of Argentina in planning and executing a program to commercialize the commuter railroads and subway system in Buenos Aires. Mercer is now assisting the Government in establishing a policy to govern the commercialization program, segmenting the rail lines, developing the RFQ and RFP for the lines, locating and qualifying potential bidders in North America, Europe, and the Far East, working with those bidders to promote interest in investing in Argentina, and evaluating the statements of qualifications and proposals submitted by the bidders.
- Mr. Rennie directed a strategic planning study for Deutsche Bahn (DB), which was used to develop organizational structures and practices for DB's participation in the commuter rail sector.
- Mr. Rennie co-managed a major multiyear strategic study for one of Europe's largest publicly owned railways. The study identified historical freight traffic trends and future projections, based on the changing European logistics and distribution environment. The study also analyzed major segments of the passenger transportation market to identify opportunities for cost and productivity improvements. For this project, Mercer employed a comprehensive internal and external benchmarking approach that provided a method for statistically comparing the performance of the client railroad with its own best practices and those of other international railways. The project also focused on developing a set of investment priorities for both public and private funding, and it established a wide range of sales concession and franchising strategies for the restructuring of the railway.

Before joining Mercer, Mr. Rennie held various senior positions at the Boston and Maine Railroad. He is a member of the Transportation Research Forum and the Council of Logistics Management.

Mr. Rennie holds a B.S.B.A. in accounting from the School of Business Administration at Georgetown University and an M.B.A. with a concentration in transportation and logistics from the University of Minnesota.

Mercer Management Consulting, Inc.

Allan E. Kaulbach

Mr. Kaulbach, a Vice President in Mercer's Transportation Group, leads Mercer's worldwide transportation transactions and asset management practice. He has over 20 years of experience in the railroad industry as an ICC attorney, private practitioner, regional railroad executive, and consultant. In his extensive involvement with Mercer's large-scale railway restructuring assignments in North America, South America, South Africa, the Pacific Rim, and Europe, Mr. Kaulbach has focused on the transactional, institutional, and legal elements required in complex political environments to support restructuring, privatization, and commercialization of transportation enterprises.

Mr. Kaulbach's recent projects include the following:

- For the South Africa Rail Commuter Corporation (SARCC), he is leading the Mercer team that is advising the SARCC and Metrorail, the incumbent service provider, on developing a negotiated concessioning agreement.
- For Ferrocarriles Nacionales de Mexico (FNM), the Mexican national railway, he served as a senior project advisor in designing restructuring options and a privatization strategy that has resulted in two long-term concessions to consortia, including North American Class I railroads.
- For commuter rail lines in Argentina and for freight lines in Chile, he co-led the Mercer team that developed a privatization strategy and successful divestitures to international consortia.
- For British Rail, he managed Mercer's study of the possible economic impacts of open access.
- For the World Bank, he was senior project advisor on a study of private financing of toll roads.
- For an international group of private investors, he co-led the acquisition due diligence team for investment in a Pacific Rim railway.
- For members of an international consortium, he directed Mercer's due diligence team supporting the consortium's acquisition of the passenger operations of a Pacific Rim, government-owned transport company.
- For Queensland Rail in Australia, he directed a strategic review of the impacts of competitive access and conducted a seminar for senior government officials on worldwide experience in railway reform and restructuring.
- For a joint labor/management steering committee of the Chicago Transit Authority (CTA) and Regional Transportation Authority in Chicago, he is co-leading a strategic review and implementation process for commercialization options at the CTA.

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Allan E. Kaulbach

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- For Grand Trunk Corporation, he led the Mercer team advising on a divestiture strategy for its subsidiary, the Central Vermont Railway, which resulted in a sale to a regional railroad.
- For a regional railroad holding company, he is leading the Mercer advisory team on a divestiture strategy for the company and its subsidiaries.
- For the Long Island Rail Road, he led the Mercer team advising on a divestiture strategy for its freight operations, which resulted in a sale to a regional railroad.
- For a Midwestern state, he was project manager and advisor to senior Department of Transportation officials in a study assessing alternative use strategies for its rail assets, and in the implementation of the study's recommendations.
- For CS First Boston and the Board of Directors of Kansas City Southern Industries, he led Mercer's development of strategic options for the Kansas City Southern Railway.
- For Amtrak, the U.S. national passenger system, he served as Mercer's project manager and as advisor to Amtrak's senior management in designing a long-term strategic plan and restructuring of the railroad into strategic business units.
- For a North American railroad, he directed an unbundling analysis and implementation strategy for the disposition of real estate rights and assets located on a 100-mile corridor between two metropolitan areas.

Before joining Mercer, Mr. Kaulbach served as a vice president, director, and member of the executive committee of the Providence & Worcester Railroad Company (P&W). Before joining the P&W, he was in private law practice in Washington, D.C., specializing in transportation and administrative law. During the reorganization of Penn Central and other bankrupt railroads into Conrail pursuant to the Regional Rail Reorganization Act of 1973, Mr. Kaulbach served in the Office of Public Counsel, Rail Services Planning Office, Interstate Commerce Commission. He served as public counsel to several New England states and closely supervised and coordinated the field efforts of attorneys in 17 states.

Mr. Kaulbach was a founding member and vice-chairman of Regional Railroads of America. He received a B.A. in English from Fairfield University and a J.D. from Georgetown University Law Center. He is admitted to practice in the District of Columbia.

Mercer Management Consulting, Inc.

Appendix B. Qualifications and Experience of Mercer Management Consulting, Inc.

Focus on Growth

For a quarter of a century, Mercer Management Consulting (Mercer) has been helping senior executives of major corporations lead their organizations to growth and prosperity in the face of industry upheaval, marketplace change, and competitive realignment. Our in-depth, integrated knowledge of customers, competitive economics, and alignment enables us to formulate creative yet practical strategies for long-term business success.

Drawing on the full talents of our 1,100-member international staff, we design our consulting teams to include the mix of functional expertise and industry knowledge best suited to each client's needs, while at the same time maintaining a general management perspective. Our reality-based approach to consulting consistently produces tangible, substantial results for clients, helping them achieve their full growth potential, enhance their financial and operating performance, and maximize their shareholder value.

Mercer maintains offices in Boston, Buenos Aires, Chicago, Cleveland, Hong Kong, Lisbon, London, Madrid, Montreal, Munich, New York, Paris, Pittsburgh, San Francisco, Toronto, Washington, D.C., and Zurich. The firm is a member of the Mercer Consulting Group, the global consulting organization of Marsh & McLennan Companies, Inc.

Mercer's private sector clients – most of them *Fortune 500* firms – include a wide variety of transportation companies, consumer products firms, retailers, industrial companies, financial institutions, travel and leisure companies, telecommunications service companies and equipment manufacturers, electric and gas utilities, and other energy companies. Mercer's public sector clients include many of the world's largest government-owned railways, international financing institutions such as the European Bank for Reconstruction and Development, the World Bank, and the U.S. Trade and Development Agency; national and state governments; regulatory agencies; and operating authorities around the world.

Transportation Consulting

Mercer's Transportation Group is one of the largest consultancies in the world, providing a broad range of assistance to transportation carriers and to the users and regulators of transportation services. Mercer is actively engaged in projects across the full range of the transportation sector. The Group also offers capabilities in international market research, evaluating new business opportunities, developing strategic plans and specific marketing plans, designing the organization structures needed to manage businesses, and implementing transportation services.

Mercer's transportation clients include national and regional governments on six continents as well as many of the world's largest railroads, motor carriers, leasing companies, and industrial and consumer manufacturing firms.

Mercer's Rail Practice

Mercer's Rail Practice employs the largest and most experienced staff in the world dedicated to the rail industry and is widely recognized as the leading management consultancy to state-owned and private freight and passenger railroads. It has carried out major strategic, operational, and financial planning and evaluation assignments for nearly all major railroads in North America and for state-owned railways in Europe, South America, and the Pacific Rim.

Mercer is known for its innovation and creativity. Mercer staff were heavily involved in the restructuring of the bankrupt northeastern U.S. railroads into Conrail, both as consultants and as senior managers at Conrail. Mercer also spearheaded the regional railroad movement in the United States following deregulation, and has led the development of unique public-private partnerships and operating agreements that have helped railroads recover from bankruptcy and compete effectively in a deregulated environment.

Selected Mercer rail projects

- Mercer recently advised the Uruguay Ministry of Transportation and State Railroad Administration (AFE) on strategic options for restructuring AFE. After providing AFE with a diagnostic assessment of its current operations, Mercer analyzed its potential market, projected AFE's financial performance under alternative operating and market scenarios, and evaluated its strategic options based on the interests of the key railroad stakeholders.
- Mercer is helping the Government of Peru with the complete privatization of its rail and port operations. Mercer is establishing goals and objectives, performing financial modeling to estimate the value of each asset to be privatized, formulating a concession strategy, proposing adaptations of the current legal and regulatory framework to fit the needs of foreign investors, and assisting with promotional aspects and the bidding process.
- For the Government of Chile, Mercer managed the sale of a majority interest in its railway freight operating company. A key responsibility of Mercer has been helping to structure the institutional relationship, embodied in an operating contract, between the freight operating company and the state-owned railway infrastructure company.
- Mercer is advising the State of Rio de Janeiro on the concessioning of Flumitrens, the commuter rail company for the Rio de Janeiro metropolitan area, which oversees 264 route-kilometers and 95 stations on five principal lines. The 25-year concession contract will cover the operation, management, maintenance, and commercial development of the Flumitrens network, and will involve managing a major capital investment program to rehabilitate rolling stock and infrastructure. The investment program will be funded by the Government, with partial financial support provided by the World Bank.

Mercer has conducted a financial analysis of the concession, advised the State on key issues concerning the concession framework and bid process, identified potential international concessionaires, and organized a "road show" to present the Flumitrens opportunity to potential bidders. Mercer will also assist the State in evaluating concession bids.

- Mercer helped the Government of Gabon with the concessioning of its national railway system. Mercer first conducted a detailed assessment that covered such areas as: evaluation of infrastructure, rolling stock and other physical assets, and human resources; assessment of service levels and fare structures; analysis of the legal and regulatory environment; analysis of current traffic and development of traffic forecasts; and evaluation of the railroad's cost structure, operating efficiency, and performance. Mercer then evaluated the feasibility of concessioning the railway from technical, legal, economic, and financial perspectives, in order to develop a solid framework within which the Government could evaluate prospective bids. This step included multiple

subtasks such as: assessing the financial viability of the new organization and clarifying its rights and obligations vis-à-vis its employees; establishing procedures for equipment transfer or lease; and developing a proposal for railway personnel who will not be retained. Mercer also drafted legal documents pertaining to the concession, including the master concession contract, a track usage agreement, and a pro forma equipment lease agreement.

Mercer also assisted with the bidding and selection processes and prepared all related documentation. The sales prospectus developed by Mercer included detailed information about both the country and its transport and railway sectors, as well as relevant regulatory, bidding, and contractual documents. Throughout the project, Mercer provided ongoing implementation assistance to the Government of Gabon.

- For the national railway of Chile, Mercer developed a strategy to privatize its freight services. Mercer evaluated the railway's freight operation and developed a strategy to ensure successful privatization while securing a fair return on the value of state-owned assets. Mercer prepared the sale prospectus and terms of reference, worked with the railway to solicit bidders internationally, and provided information requested by potential bidders. The railway was ultimately sold to a single bidder. Mercer is also assisting with the ultimate transfer of assets.
- For the Kazak Ministry of Transport, Mercer helped to position the Kazakstan railway system for restructuring and commercialization. Funded by the World Bank, the project involved training Kazak personnel in the principles of market-economy railway systems and developing a series of recommendations for the reform of the railway sector in Kazakstan. The in-depth training program, composed of 17 Kazakstan-based seminars for railway and Ministry of Transport personnel, included a three-week study tour to railways in Europe and the United States. Mercer's recommendations to the Kazak Ministry of Transport addressed the railroad's organizational structure, its linkages to non-rail sectors in the Kazak economy, capital planning, arresting infrastructure deterioration, and improving commercial capabilities.
- Mercer helped the Government of Argentina to privatize its commuter railroad lines and subway by establishing a privatization strategy, preparing marketing materials and bidding documents, and arranging follow-on visits by potential operators to inspect the facilities in Buenos Aires. Mercer helped to establish government agencies for overseeing the safety and commercial activity of the newly privatized rail sector, and worked to recommend a structure and organization for them. Mercer then prepared a mission statement clearly defining jurisdiction, objectives, and goals of the new agencies; an organizational structure; and a strategic plan.
- For the Government and national railway of Mexico, Mercer developed a financial diagnosis and restructuring plan. Mercer used a network model and market research to analyze the economic situation, conducted an institutional analysis of the relationship between the railway and primary stakeholders, and developed a preliminary set of restructuring options. Mercer tested those options and recommended a restructuring plan to the Government and the railway. Mercer is now implementing the rail

privatization with the government's investment banks. Mercer's role is to evaluate the market and growth potential for the new railroads, present the opportunities to bidders, and help the government set the minimum bidding price for each concession. The Northeast Railroad was sold in late 1996 to Transportacion Ferroviaria Mexicana (TFM), a consortium of Kansas City Southern and Transportacion Maritima Mexicana. The Pacific North Railroad was sold in June 1997 to Grupo Ferroviario Mexicano (GFM), a consortium of Grupo Mexico, Grupo ICA, and Union Pacific. Mercer is currently helping to privatize several light-density lines.

- Mercer helped Amtrak in a major strategic restructuring. Amtrak was confronted with declining customer service (confused roles, responsibilities, and accountabilities) and increasing costs. Although it had a stovepipe, functional organization, it also had a new chairman committed to change. Amtrak asked Mercer to help develop a customer-focused organization with the requisite organizational structure to ensure accountable performance in reducing costs substantially and enhancing revenues. Mercer created a customer-focused process inventory and prepared process-focused organization designs for its strategic business units, including developing a detailed implementation plan.
- Mercer was retained by the RTA/CTA in Chicago to facilitate and support the work of a joint management-labor task force in developing and documenting a preliminary list of commercialization opportunities. The project used Mercer's unbundling methodology as well as financial models developed specifically for the RTA and its component transit operations.
- The Government of Colombia asked Mercer to study the operations of two rail companies. The first had been formed to operate rail freight services; a majority of it was privately owned, but it had a large government stake. The second had been formed to own and maintain the rail infrastructure; it was wholly owned by the government. Mercer analyzed the operations of each, particularly their interactions, and recommend ways to improve them both separately and together. The government is currently implementing Mercer's recommendations.
- Mercer helped to restructure Czech Railways (CD) from a centrally managed government entity to a commercially oriented business, competitive with road in both cost and service. The Czech Government had made broad policy decisions (for example, with open access, and with CD as an independent public corporation), but needed an organization and operation for the new environment. Working with two local consulting firms, Mercer determined CD's profitability by line of business and line section (Phase I of the assignment). In Phase II, Mercer performed network restructuring and line divestment, helped to dispose of non-core assets, improved productivity, developed freight and passenger marketing and pricing, established an organization structure, created performance measures, and developed a new strategic plan.
- Mercer developed a comprehensive restructuring plan for the Polish State Railways (PKP), the largest state-owned enterprise in Poland. Mercer worked with the PKP to develop a new operating strategy for freight and passenger services that will

substantially reduce government operating subsidies. One of the project's key analytical tools was a railway financial planning, control, and simulation computer model that Mercer developed to project PKP financial and operating performance under a variety of restructuring options. Mercer also conducted a comprehensive analysis of PKP's operations and operating environment, including examining the Polish economy and the rapidly evolving European transport market. To help in implementing the restructuring, Mercer analyzed the characteristics of long-term demand for both freight and passenger services and identified the network and rolling stock strategies that PKP should pursue.

- For MAV, the Hungarian state railway, Mercer helped to develop and implement a comprehensive business plan for positioning the railway for restructuring. Mercer's recommendations to MAV included network restructuring and the development of system efficiency improvement options. Mercer also advised MAV on developing a commercially driven organization, and on rethinking the role of the government in fulfilling the mandate of the post-reform rail system. Mercer's recommendations were supported by a series of "what if" scenarios, which measured the impact of different management actions. Mercer identified long-term customer demand and analyzed network and asset utilization requirements as part of the effort.
- For British Rail and the British Department of Transport (DOT), Mercer evaluated the structural options for the privatization of the railway's freight businesses. A key element of this study was a thorough analysis of the tradeoffs between the benefits of a more fragmented rail industry, generating efficiency improvements through greater competition, and the effects of fragmentation on the economies of scale. The study also addressed the viability of the privatized rail industry and whether its current customers wanted to run their own rail operations. As a final step, Mercer developed an implementation program for its recommended options.
- Mercer has performed a number of studies for the European Commission DGVII (Transport) that have been used as the basis for EC DGVII policy. The studies include:
 - Analysis of EU railway's financial position and action taken by governments to improve railway finance
 - Analysis of EU governments' policies on shipping, including tax and incentives
 - Evaluation of European supply chains and transport costs for major industrial and agricultural sectors. This evaluation is designed to facilitate the understanding of how changes in the services and costs of rail and other transport modes are likely to affect each sector.
 - A detailed review of pan-European rail cost structures and compared them to cost structures for other modes of transport. This information is used by EC DGVII staff in their consideration of transport policy issues between rail, road, and water.
- For the Portuguese MOT, Surface Transport Directorate, Mercer conducted a comprehensive review of infrastructure and equipment requirements across various

transport sectors in Portugal. Mercer's recommendations formed the basis for regulation proposed by the government.

- For the European Commission DGVII (Transport), Mercer evaluated European supply chains and transport costs for major industrial and agricultural sectors. This evaluation is designed to facilitate the understanding of how changes in the services and costs of rail and other transport modes are likely to affect each sector.
- For a state-owned railroad in a Midwestern U.S. state, Mercer evaluated the long-term commercial viability of 19 line segments operated by shortlines and regional railroads. Mercer developed a range of strategies for commercializing and privatizing the segments according to a set of screening criteria developed by the railroad's governing authority to ensure maximum profitability while maintaining the state's public interest obligations. Mercer is now assisting the State in the implementation of that strategy.
- Mercer provided strategic analysis and financial advice to the Northern Indiana Commuter Transportation District (NICTD) in the restructuring of commuter and freight services over its lines. When Mercer was retained, the freight railway was in bankruptcy and had obtained authority to discontinue the commuter operations funded by NICTD. Mercer developed a long-term plan for NICTD with a series of operating and ownership options. Using proprietary planning models and detailed analysis, Mercer selected the best option that used the least amount of public funds. Mercer negotiated sales prices and developed a strategy for the relationship between NICTD and the private tenant freight carrier. Mercer also helped assess the economics of the freight and passenger franchises as well as the value of other franchises inherent in the right-of-way (e.g., for utility transmission lines).

Mercer helped to maximize the value of each franchise, by developing pre-qualifications for potential freight franchisees and selecting from among the qualified bidders. Mercer also assisted in designing the institutional structures and agreements governing line operations. Sufficient value was generated to pay all corridors in the bankruptcy in full and to permit the railroad to be discharged from bankruptcy proceedings within a year.

- For the State Rail Authority of New South Wales, Mercer reviewed and updated SRA's strategic plan for the Sydney metropolitan and intercity passenger services, to provide a new emphasis on commercial, competitive transport practices. Mercer:
 - Reviewed SRA's policy framework to define clear measures of success
 - Updated projected operating and financial performance and compared current performance with the previous five-year plan
 - Reviewed capital spending plans to ensure that investments would be appropriate and would help SRA achieve the new best-practice targets and maximum value for the money

- Recommended new overall financial and management frameworks, including reevaluating railway activities and business units that might be provided more efficiently commercially or by alternative sources
 - For one of the 10 largest Class I U.S. railroads, Mercer conducted a comprehensive organization planning and design study with the senior management team that led to a fundamental restructuring of railroad operations and customer service. The study identified significant improvements required to the organization's structure, functional costs, and management roles and responsibilities. In addition to producing a blueprint for future organizational changes, the study directly led to significantly improved focus on service quality, and improved customer relationships, both external and internal.
 - Four Mercer staff members led a series of assignments that resulted in the restructuring of New Zealand Railways (NZR) – the 3,000-kilometer railway and ferry operation in New Zealand. The work involved an assessment of changing market conditions in the face of near-total deregulation of surface transportation during the 1980s. The Mercer team directed a series of assignments including market research, operations reform, business restructuring, and labor reform. It involved the introduction of new technologies in a number of areas, the design of competitive services, and the development of methods to build a competitive cost structure for the railway. In the process, the number of NZR employees was reduced from nearly 25,000 to about 3,800, while traffic remained relatively stable. The restructuring was so successful that the railway was sold to private interests for about NZ\$400 million in a worldwide competitive bidding process.
- Mercer has also provided due diligence reviews of the railway's business plans and nonrail operations to an investment group, and has counseled TranzRail on organizational, financial, and service quality issues.
- For the World Bank, Mercer has participated in various activities involving railways in China. A Mercer staff member is part of a select group of executives that formed the Bank's railway reform foreign advisory panel. This group worked with Chinese Railway and other government officials to review productivity, executive compensation, the provision of social services (including housing, healthcare, and education), and opportunities for economic diversification. As a part of this program, several groups of Chinese Railway and government officials traveled to the United States to observe railway activities and methods, discuss reengineering, productivity improvement, benchmarking, market-based employee compensation, organization planning, and employee development and continuing education.
 - For the Government of Colombia, Mercer evaluated international bids for upgrading a rail line linking a port to a coal mine in Colombia. The proposals had two elements: a technical element on how the work would be carried out and what materials would be used in both the upgrading and the installation of the signal system; and a financial element in which the government asked each contractor to find financing for the project, which it would then pay off. The government was interested in what the present value of each of the financing proposals would be. Mercer inspected the line,

evaluated each of the proposals, scored them technically, evaluated and scored the financing, and came up with an overall score and a recommendation for the government, which accepted Mercer's recommendation.

- Mercer worked with a major European railway to improve the performance of its trainload freight operations. In the first phase of the project, Mercer developed a profit improvement plan that addressed all aspects of the railway's trainload freight operations. Mercer determined the conditions under which rail was competitive against motor carrier; assessed the potential to reduce costs through better management of train crews, maintenance, terminals, overhead, etc., and to reduce the capital requirements of the business through better utilization of locomotives and wagons; developed techniques to improve revenue by repricing existing railway business on a route-by-route, customer-by-customer basis; and developed a plan that quantified the linkage between productivity levels and overall business sizing.

In the second phase of the project, Mercer assisted senior railway managers in implementing specific areas of the profit improvement plan. Profit improvement at the railroad has been dramatic, and other gains have been made through major train plan and timetable revisions.

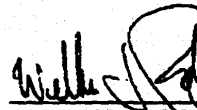
- For the Australian Federal Department of Transport, Mercer and its sister company NERA worked with Symonds Travers Morgan to assess the options for management of the Australian interstate track network, including the option of establishing Track Australia. The work included an evaluation of the issues of an integrated versus separated infrastructure, the likely future competitive scenarios for interstate freight traffic, the implications of the different track options, and the options for the Federal Government in the relationship with the States.
- For the State Rail Authority of New South Wales (SRA) and in cooperation with an SRA/governmental oversight unit, Mercer conducted a strategic review of each SRA unit: FreightRail, CityRail, and CountryLink, as well as administrative and engineering functions. The strategic review included the development of new benchmark performance measures; a revised organization structure; recommendations for reform within each unit; and a strategy to promote growth and improve cost performance.
- For the State Rail Authority and the government of New South Wales, Mercer extended the SRA strategy work to include governance issues and organization recommendations. Governance issues included recommendations regarding the adoption of public service contracts for all subsidized services. Organizational recommendations included the development of an organizational framework for an SRA track access unit and a usage fee-based access system for commercial SRA units as well as the independent service providers that were being licensed by the government of New South Wales. This framework was the precursor to the organization and governance structure adopted by the Government.

- For the Dutch Ministry of Transport, Mercer defined the key principles of the different access-charging systems and assessed the impact of each of the key variables. Mercer worked in conjunction with the Dutch Ministry of Transport infrastructure department, the rail department, as well as the Dutch railway (NS). This work has been used as the basis for discussions on what kind of transport and competitive policy should be used in the Netherlands.
- In June 1996, the European Commission published a white paper with the objective of revitalizing the rail sector. One aspect of the paper was to promote rail freight via "freight freeways," or "freightways." The Commission of European Railways (CER) asked Mercer to develop a proposal to the European Commission for setting up a pragmatic application of this concept. The European rail freightway concept presents an opportunity to accelerate the development of cross-border rail freight in the short term through practical steps related to infrastructure access and use. The main objective has been to provide licensed railway undertakings with a means to be more responsive to the market. Mercer and CER have successfully completed an initiative to identify paths that are comparable to existing paths and that have the potential of cutting waiting times at borders by almost 80 percent and increase commercial speed by as much as 20 percent. These paths can be readily made available on two study corridors. Pricing principles elements are in the process of being established so that new services along the study corridors can be in place by January 1998.
- In a multiphased project for a major European Department of Transport, Mercer developed strategies for implementing the EC's directive for competitive access. Mercer described the effect of regulatory policy on the service and financial performance of railroads in other countries; profiled the structure of contractual relationships between track users and rail service operators in those countries; detailed the potential for efficiency savings between the railway and potential trading partners; provided in-depth case studies of recent franchising experiences; and provided a financial planning model for analyzing the implications of open access on operating costs, revenues, and overall subsidy costs. Mercer's analysis and model are permitting the railway to respond to and develop proposals for access to its system by other partners and to assess opportunities for "unbundling" and commercializing assets.

Verification

I, William J. Rennie, verify under penalty of perjury that I am a Vice President of Mercer Management Consulting, Inc., that I have read the foregoing document and know its contents, and that the same is true and correct to the best of my knowledge and belief.

Executed on March 25, 1998.



William J. Rennie

Verification

I, Allan E. Kaulbach, verify under penalty of perjury that I am a Vice President of Mercer Management Consulting, Inc., that I have read the foregoing document and know its contents, and that the same is true and correct to the best of my knowledge and belief.

Executed on March 25, 1998.


Allan E. Kaulbach

BEFORE THE
SURFACE TRANSPORTATION BOARD

EX PARTE NO. 575
REVIEW OF RAIL ACCESS AND COMPETITION ISSUES

COMMENTS OF THE BURLINGTON NORTHERN AND SANTA FE
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March 26, 1998

BEFORE THE
SURFACE TRANSPORTATION BOARD

EX PARTE NO. 575
REVIEW OF RAIL ACCESS AND COMPETITION ISSUES

**COMMENTS OF THE BURLINGTON NORTHERN AND SANTA FE
RAILWAY COMPANY ON RAIL ACCESS AND COMPETITION**

The Burlington Northern and Santa Fe Railway Company ("BNSF") submits these comments in response to the Surface Transportation Board's request in Ex Parte No. 575 for comments concerning access and competition issues in the rail industry. These comments, together with the written statement of Robert D. Krebs, Chairman, President and Chief Executive Officer of BNSF, are being submitted for consideration by the Board in order that it may respond to inquiries from Congress on such issues as part of its legislative oversight.

BNSF has a vital interest in the issues being considered in this proceeding. BNSF is the second largest Class I rail carrier in the western part of the United States. BNSF also is a member of the Association of American Railroads ("AAR") and joins in the comments submitted on behalf of the AAR in this proceeding. BNSF files these separate

comments to address particular points and to provide specific information about BNSF in response to the Board's request for data, studies and proposals for action.

EXECUTIVE SUMMARY AND OVERVIEW

The service problems the rail industry has faced since mid-1997 in the West are serious and have shaken the confidence of rail customers that the railroads can meet their needs for efficient and reliable service. However, as shippers, industry representatives and the STB have recently observed, these service problems are not caused by a lack of competitive access. Rather, the problems are caused by insufficient rail capacity that can only be remedied by continued substantial investment in infrastructure. The Board, therefore, should focus on how best to position the rail industry to be able to attract the capital necessary to make the on-going infrastructure investments required to meet the growing transportation needs of shippers and the public.

History clearly shows that deregulation of the rail industry under the Staggers Act of 1980 has been a resounding success. Deregulation, including "differential pricing" under Staggers, has created a climate in which rail carriers have been able to make significant capital expenditures to improve the U.S. rail infrastructure and to engage in vigorous intramodal and intermodal competition. Those investments have led directly to the revitalization and increased competitiveness of the industry.

Forced rail access is, however, not a solution to address the industry's current capacity constraint problems. In fact, by allowing additional carriers to operate on already congested lines, forced rail access would exacerbate the existing capacity

problems with operational chaos and heightened safety concerns. Such access would threaten the industry's ability to remedy the lack of capacity and to continue its post-Staggers investment performance, enhanced competitiveness, and capacity expansion. Forced rail access also would require the reinstitution of governmental regulation similar to the pre-Staggers era with the Board determining rates, terms and conditions of service, scheduling practices, and other issues. This return to such control by the government would reverse the fundamental principles of the Staggers Act and undo the benefits to railroads and shippers which that Act produced.

The STB should, therefore, not endorse any legislative or regulatory initiatives that would stifle the railroad industry's ability to attract the capital to make the investments necessary to serve its existing customers in a safe and reliable way and to attract new customers and additional traffic through competition with other modes of transportation. It is vital that a demand-based pricing structure be maintained.

The existing statutory and regulatory protections provide shippers with adequate opportunities to seek relief from rate or service problems they may face. However, BNSF recognizes that some shippers believe that the existing procedures do not afford them relief in a timely manner and are too difficult and cumbersome. BNSF believes that a measured approach examining possible options for the STB to consider to address these concerns of shippers is justified, and BNSF would be pleased to join in such an effort.

I. Deregulation of the Rail Industry Under the Staggers Act of 1980 Has Been a Resounding Success.

Deregulation under the Staggers Act has been dramatically successful, leading to a much more efficient and financially stable investor-owned rail transportation system. By any reasonable measure, the industry in general and BNSF in particular have responded to the commercial opportunities presented by the Staggers Act and have produced tangible benefits for customers -- lower rates, improved service and safety, expanded capital investment, increased productivity and efficiency, vigorous competition, and revived economic health. Even opponents of the deregulatory measures embodied in the Staggers Act and railroad critics agree that the industry performance since 1980 has exhibited a remarkable, positive transformation.

This transformation under Staggers is in stark contrast to the pre-Staggers era. Before 1980, due largely to the heavy burdens of regulation, the railroad industry's financial health was deteriorating, the condition of rail plant and equipment was increasingly poor, and it could not compete effectively with other modes of transportation. According to a comprehensive 1990 General Accounting Office ("GAO") study, pre-Staggers regulation crippled the industry: "Regulation reduced the managerial control and flexibility the railroads needed to react to changing market conditions."^{1/} The negative impact of regulation on shippers and the public was dramatic and led to imperiled service and safety.

^{1/} **Railroad Regulation: Economic and Financial Impacts of the Staggers Rail Act of 1980**, GAO, RCED-90-80, May 1990, at 11-12.

Not only were railroads going bankrupt, but the condition of rail plant and equipment was poor. Years of declining profits led to deferred maintenance of rights-of-way, and over time plant and equipment deteriorated. Prolonged deferrals in maintaining and replacing worn-out capital stock affected safety and the quality of rail service.²⁷

The health of the industry before and after Staggers is clearly indicated by the financial status of the carriers. Healthy carriers can better compete and add value for shippers. A financially distressed industry cannot. In 1976, about one third of Class I railroads were earning negative returns on investment, while several were in bankruptcy proceedings.²⁸

From an operations standpoint, shippers and the public, in turn, suffered. Shippers could not rely on rail carriers as near-term or long-term service providers, and safety was not a focus of the industry. Transit times were often measured in weeks, and only rudimentary information systems were available to provide shippers with information about their shipments. Truck competitors were increasing their market share due to their greater reliability, increasingly modern and higher capacity equipment, and better dock-to-dock transit times. Rail carriers lost market share steadily for over fifty years and bottomed out just prior to passage of the Staggers Act at around 38% of intercity freight traffic.²⁹

²⁷ Id. at 11.

²⁸ Id. The GAO reported that the railroads' rate of return on shareholders' equity was only 1.9% in 1975 and averaged 2.5% from 1975 to 1979. This contrasts sharply with shareholder return of 15% and 12% for manufacturing companies and utilities, respectively, for the same time frame. Id. at 10-11.

²⁹ Id. at 10.

Congress recognized that federal legislative reform was required to save the nation's private investor-owned rail transportation system. The Staggers Act deregulated the railroad industry and provided that market forces -- rather than the government -- would play the primary role in setting rates as they do in the rest of the U.S. economy. Congress intended to ensure that carriers would have the opportunity to achieve revenue adequacy in order to save the nation's rail system and to provide the means for carriers to maintain and improve their physical facilities.⁵⁷ These goals were again endorsed in the Interstate Commerce Commission Termination Act of 1995 ("ICCTA"), when Congress required the Board to ensure that carriers have the opportunity to earn revenues adequate to cover costs, allow replacement of needed assets, and provide a fair return on investment.⁵⁸ Thus, both the Staggers Act and the ICCTA turned to market forces, rather than government regulation, to preserve and improve the nation's rail service, and both recognized that rail carriers must be revenue adequate to prevent the collapse of the industry.⁵⁹

⁵⁷ "Earnings by the railroad industry are the lowest of any transportation mode and are insufficient to generate funds for necessary capital improvements . . . The industry's failure to achieve increased earnings will result in either further deterioration of the rail system or the need for additional Federal subsidy. Modernization of economic regulation of railroads, with greater reliance on the marketplace, is essential to achieve maximum utilization of railroads, to save energy and to combat inflation.

" . . . The overall purpose of the Act is to provide . . . the opportunity for railroads to obtain adequate earnings to restore, maintain and improve their physical facilities while achieving the financial stability of the national rail system." H.R. Conf. Rep. 96-1430, at 79-80 (1980), *reprinted in* 1980 U.S.C.C.A.N. 3978, 4111 (1980).

⁵⁸ See 49 U.S.C. §§ 10101(3), 10704(a)(2) (Supp. I 1996).

⁵⁹ To that end, Congress has directed the Board to "make an adequate and continuing effort" to ensure that rail revenues are sufficient to cover total operating

Since passage of the Staggers Act, Congress and the STB have endorsed a "differential pricing" structure that permits railroads to set their rates based on what markets and competition will allow, with a limit on the rates for traffic over which a railroad has market dominance. Differential pricing is critical to the railroad industry because, unlike other transportation modes, rail carriers privately fund the cost of the system's infrastructure. Because the cost of that infrastructure is so enormous, railroads must generate revenue well in excess of their variable costs to maintain their ability simply to stay in business.²⁷

The differential pricing structure has enabled the railroad industry to move closer to revenue adequacy, thereby substantially improving the industry's long-term financial outlook and its ability to make investments to improve service to shippers, to make investments in safety, to reduce rates, and to compete aggressively with other transportation modes. The freedom to set prices in response to market demand gave

expenses, including return to capital. 49 U.S.C. § 10704(a)(2).

²⁷ Indeed, the ICC and the Board have "consistently recognized that differential pricing is crucial to the viability of the industry." Ex Parte No. 445 (Sub-No. 2), Intramodal Rail Competition -- Proportional Rates, (ICC served May 2, 1990) at 4. See also Coal Rate Guidelines, Nationwide, 1 I.C.C.2d 520, 523, (1985), aff'd sub nom. Consolidated Rail Corp. v. United States, 812 F.2d 1444 (3d Cir.1987); Potomac Elec. Power Co. v. ICC, 744 F.2d 185, 193-194 (D.C. Cir. 1984) ("The concept of differential pricing . . . necessarily contemplates that the carrier will maximize its profits on traffic for which it has no competition so as to offset its lower earnings on competitive traffic. It does not aid analysis to describe a carrier's rate on non-competitive traffic pejoratively as producing 'monopoly profits.'"); Mr. Sprout, Inc. v. United States, 8 F.3d 118, 124-125 (2d Cir. 1993) ("Congress in the Staggers Act recognized that railroads must engage in 'differential pricing.' . . . Railroads must charge above fully allocated costs on captive traffic if they are to achieve revenue adequacy and stay in business."), cert. denied, 512 U.S. 1205 (1994).

railroads the incentive to cut costs and achieve efficiencies so that they could compete in the market and attract more business and more customers.

II. The Rail Industry's Success Under the Staggers Act Is Attributable to Increased Rail Investment.

While the success of the Staggers Act can be measured in many ways, the key driver of the industry's success has been increased investment -- the sine qua non of improved performance. As the Board is aware, the railroad industry is a highly capital intensive industry. That is, it takes substantially more investment in fixed plant and equipment in the rail industry to produce a dollar in revenue than it takes in other sectors of the economy.⁹⁷ As described below, the Staggers Act led to the revitalization of the industry by enabling the industry to generate the funds necessary to meet its investment requirements for growth, improved service and vigorous competition. Industrywide capital expenditures in roadway, structures and equipment have risen substantially from \$2.97 billion in 1987 to \$6.10 billion in 1996.¹⁰⁷ In addition, capital expenditures by

⁹⁷ For example, the capital output ratio, or the ratio of investment to revenues, for Class I railroads has hovered around 1.75 in recent years. This compares to .86 for the average of all firms in the Standard and Poor Industrial index and .71 for the trucking industry. See Verified Statement of Robert W. Anestis ("V.S. Anestis") at 7-8, Comments of the AAR, Docket Nos. 41242, et al., Central Power & Light v. Southern Pacific Transportation Company (filed October 15, 1996).

¹⁰⁷ Association of American Railroads, 1997 Railroad Facts, at 43 (1997) ("Railroad Facts"). Although these figures are not in constant dollars, they understate the increase in capital expenditures as a function of miles of track owned and number of freight cars in service. In 1987, for example, Class I railroads had a total of 748,523 freight cars in service operating on 220,518 miles of track. Id. at 50, 44. By 1996, Class I railroads had 570,865 freight cars in service operating on 176,978 miles of track. Id. Therefore, the capital expenditures in 1996 per mile of track and number of freight cars is up considerably from comparable 1987 figures.

Class I railroads have grown significantly over the last several years: \$4.2 billion in 1993, \$4.9 billion in 1994, \$6.0 billion in 1995, and \$6.1 billion in 1996. Railroad Facts, at 43.

Other indicia of financial health reveal similar upward trends. Railroads have made substantial gains in productivity and efficiency since 1980, in part because of industry consolidations. Freight revenue per employee has increased more than 75 percent from 1985 to 1996. Railroad Facts, at 13, 55. Freight revenue ton-miles per employee have increased over 250 percent from 1985 to 1996. Id. at 41.

The investment and enhanced competition made possible by the Staggers Act have led to an improved financial condition and outlook for BNSF. For example, as shown on Exhibit A attached hereto, traffic over BNSF's predecessor railroads in 1978 generated just under 199,000 million revenue ton-miles. By 1997, that figure had grown to approximately 429,000 million revenue ton-miles, an increase of more than 115%. In addition, efficiency has improved significantly on BNSF since the Staggers Act. For instance, as shown on Exhibit B attached hereto, fuel efficiency on BNSF increased to 385 revenue ton-miles per gallon in 1996 from 247 revenue ton-miles in 1980. Other measures of BNSF success are improved service to shippers through investment in major infrastructure projects and equipment, safety achievements, and significant reductions in rates.

Improved Service Through Massive Capital Investment. BNSF's service capacity to handle increased shipper demand has grown through massive investment in infrastructure, yards, intermodal facilities and equipment. As shown on Exhibit C attached hereto, in 1979 before the passage of the Staggers Act, the predecessor

railroads to BNSF spent approximately \$641 million on capital expenditures. By 1985, those expenditures had increased to \$1.05 billion, and by 1997 they had increased to \$2.22 billion. Indeed, in the three-year period from 1996-1998, BNSF projects total capital spending of just under \$7 billion. About \$3.5 billion of that amount is for maintenance of our infrastructure — 9.7 million ties, 3,188 miles of new rail, and over 35,000 miles of track resurfacing. The balance of the expenditures is predominantly for capacity expansion.

Major capital projects include the reopening of the 229-mile Stampede Pass line in western Washington which will increase BNSF's capacity for intermodal, grain and general merchandise to and from the midwest. This investment in the Pacific Northwest ("PNW") not only offers overall service improvement to shippers and the public as a result of expanded capacity and improved operations, but also offers environmental benefits in shorter route miles and fuel savings. The investment would never have been made if BNSF could not rely on handling long-haul grain movements for its existing shippers where those movements are the most efficient means of transporting grain to the PNW ports.

With respect to the network of north central grain gathering lines, BNSF has been investing in the branch lines that reach outlying farms and elevators across the northern United States to ensure their capacity to move unit grain trains. For example, BNSF recently upgraded the approximately 40 mile long branch line between Bottineau and Rugby, ND to enable the line to carry 286,000 tons gross weight. As a result, grain shippers on that branch line are now served by efficient unit trains at the lower rates

applicable to heavy axle unit train service. Other branch lines are currently being studied for upgrade, particularly in Montana and North Dakota. If revenues were to be seriously cut as a result of forced rail access, BNSF would be forced to look elsewhere to put increasingly scarce capital and achieve a better return.

In addition, BNSF's coal and grain shippers, as well as all other shippers on its network, have benefited from huge investments in BNSF's state-of-the-art Network Operations Center in Fort Worth, TX. That facility's sole purpose is to enhance the on-time performance and safety of train movements on BNSF's 34,000-mile network. The development of such technological advancements would clearly be undermined by forced rail access and reduced revenues.

BNSF's intermodal and carload shippers have benefited from BNSF's improvements to the Hobart Yard in East Los Angeles. That yard's current configuration limits the traffic that can be efficiently handled there, and BNSF has already invested nearly \$50 million of a total \$100 million project to buy property adjacent to the yard and to relocate the fuel and rip tracks to that property. The next phase of improvements will extend the strip track in the yard so that trains no longer have to be split into sections when they are brought into the yard. These costly improvements have positioned BNSF to take advantage of projected growth in both domestic and international intermodal traffic moving through Los Angeles and the Los Angeles basin ports. BNSF anticipates that its capacity to handle port-related traffic will grow to one million lifts per year.

In the Kansas City area, BNSF invested \$95 million in the construction of a new freight-car classification yard, one of the largest yards of its type in North America.

Argentine Yard's design and technological innovations have allowed BNSF to triple the volume of freight cars sorted at the yard to 2,400 daily. The yard is strategically located at one of four gateways to eastern railroads and has the ability to assemble trains for movement to most major markets in the United States. Kansas City is also a major rail hub where freight cars are interchanged between several major railroads. This significant commitment of capital to infrastructure increases BNSF's ability to meet its customers' expectations for transportation services, to better manage freight traffic flow throughout much of its system, and to better compete with trucks and other modes of transportation.

Investments such as BNSF's recent improvements in tracks and facilities serving the Powder River Basin would also be undermined if forced rail access were a reality and revenues declined. The Board is very familiar with BNSF's tremendous early investments in the PRB, which created access to the largest reserves of low-sulfur sub-bituminous coal in the United States. Projects such as the PRB simply could not be financed in a world of forced rail access where diminished prospects for recouping investment would reduce the available capital.

Other significant capital projects include the completion in 1998 of the rehabilitation of the 194-mile former SP Iowa Junction-Avondale line and Lafayette Yard in southern Louisiana, and the double tracking of more than 450 miles of line on some of BNSF's most important routes, at a capital expense estimated to be more than \$500 million during 1996 through 1998.

In addition, BNSF has made significant investments in locomotive and freight cars since 1996 in order to improve its competitive service to customers. In 1997 alone,

BNSF spent more than \$800 million on capital equipment expenditures. Between 1996 and 1998, BNSF will have taken delivery of 867 new locomotives, increasing BNSF's road fleet by 25%. Further, BNSF has invested more than \$150 million over the past 22 months in its information systems to provide better control over assets, to improve information flow between BNSF and its customers, and to improve overall service reliability. Continued investment in such equipment would be jeopardized by forced rail access.

The improved transit times and reliability made possible by these investments have permitted BNSF to better serve its shippers and become an integral part of their supply and distribution chains. As BNSF has obtained more accurate and timely information on its shippers' needs and its success in meeting those needs, BNSF is better able to identify areas where service improvements are necessary, and BNSF is continuing to work with shippers to find solutions to the challenges that have arisen. For example, in the forty-five-day 1997 peak UPS service season -- the largest peak season ever handled by a railroad for UPS -- BNSF handled more than 43,000 trailers without a service failure. Similarly, we are currently operating at close to 100% on-time for our coal and grain shippers, and our on-time system-wide performance for the first quarter of 1998 is exceeding 85%. BNSF plans to improve that performance in the future.

Improved Safety Achievements. Safety on BNSF has improved significantly since the Staggers Act due to the ability of BNSF to attract the capital to make the investments necessary to assure safe operations. For example, BNSF spent approximately \$17 million on its Positive Train Separation program from 1995 to 1997 and expects to spend

an additional \$6 million on that program in 1998. Similarly, in order to reduce the risk of grade crossing accidents, BNSF is spending \$10-12 million per year on grade separations, upgrading signals at crossings and road crossing surfacing. BNSF is also leading the industry in the use of electronic brakes. BNSF will spend more than \$5 million from 1996 through 1998 to equip locomotives and freight cars with such brakes. Ten train sets are already so equipped on BNSF (seven BNSF sets and three shipper-owned sets), and several additional equipped trainsets are anticipated to enter service in 1998. Further, between 1995 and 1997, reportable employee injuries per 200,000 hours worked declined by almost 40%, and lost days per 200,000 hours worked declined by more than 50%. BNSF's 1998 goal is to reduce the injury rate an additional 25% below 1997's already reduced level. However, the development and deployment of these new technologies and the improvements in safety and efficiency they can bring will require ongoing substantial capital investment in the years ahead.

Rate Reductions Derived From Market-Based, Differential Pricing. Prior to the Staggers Act, the industry was shackled by pervasive regulation of the entire range of rail operations. Staggers substituted market forces and business judgment for the slow, unpredictable and arbitrary hand of regulation, and permitted firms to establish a carefully balanced structure of rates based on demand differentials.

Virtually every shipper has benefited from post-Staggers rail rate reductions, whether or not it is served exclusively by one rail carrier. According to a recent STB study, Class I rail rates have fallen substantially since 1982. The average real rate has fallen 46.4% between 1982 and 1996, with particular commodity groups realizing even

greater percentage declines in revenue per ton-mile: coal 55.7%, intermodal 48.1%, and lumber and wood 52%.^{11/}

But not every shipper can or should pay the same rates. While the demand-based rate structure under Staggers leads to different rates for shippers in different circumstances, it ultimately results in lower rates for all shippers than otherwise would be possible. Some shippers pay more than the overall average cost of transportation while others pay less than the average cost. However, because all shippers contribute to covering the huge fixed costs of railroad plant, they all enjoy rates and services that would not be available if all rates had to reflect average cost. This system of rates can work if, and only if, carriers are permitted to differentiate rates according to market demand.

There is a strong linkage between the current differential pricing system, the substantial and growing commitment of capital investment to the sector by the financial community, and the industry's current level of performance. As stated by various investment bankers and securities analysts knowledgeable in the rail industry:

[T]he Staggers Act of 1980 and the market-oriented regulatory policies implemented since then have made it easier for the railroads to attract capital on competitive terms. With deregulation, investors have become more willing to supply capital to the industry because they are more confident that the railroads will have the opportunity to earn competitive returns. The railroads have made good use of these funds. Investments by the railroad industry since the Staggers Act have led to enhanced productivity, lower costs, improved service, and lower rates.

^{11/} Office of Economic, Environmental Analysis and Administration, Surface Transportation Board, Rail Rates Continue Multi-Year Decline, 1, 3, and 6 (Feb. 1998).

* * *

[Under forced rail access], investors would be less willing to make funds available for costly infrastructure investments because of the uncertainty that any new investments would generate competitive returns. New facilities might have to be shared with competitors, therefore the revenues generated by those facilities would be less certain. To the extent the railroads could attract capital for infrastructure investment, this uncertainty would increase the cost of raising that capital.

See Verified Statement of Investment Bankers and Securities Analysts ("V.S. Investment Bankers") at 2, 3, in Comments of AAR filed concurrently herewith in this proceeding.

The evidence is clear that the success of the Staggers Act is directly attributable to differential pricing, for without it railroads could not have generated the revenue streams which have permitted them to elevate their economic and competitive performance so dramatically.

BNSF's improved economic performance and traffic growth have been accompanied by significant reductions in rates to meet customer expectations, changing markets, and intense competition. As shown on Exhibit D attached hereto, between 1981 and 1997, the average system-wide revenue per ton-mile on BNSF decreased just over 50% in inflation-adjusted dollars from \$2.42 to \$1.20. These rate reductions have been realized by all of BNSF's traffic commodities. For instance, the average freight revenue per ton-mile in inflation-adjusted dollars for all agricultural commodities has decreased by 56% since the Staggers Act took effect. By way of one example, from 1981 to 1997, the rate charged by BN (now BNSF) for 52-car PNW export wheat from Montana decreased by 32% in constant 1981 dollars. As shown in Exhibit E attached

hereto, a Montana grain shipper in 1981 paid BN \$0.71 per bushel of wheat shipped via a 52-car unit train to the PNW for export. That 1981 rate adjusted for inflation would be \$1.26 per bushel in 1998. However, the 1998 actual rate charged by BNSF for such transportation is only \$0.86 -- 32% below the inflation-adjusted rate.

Other examples of BNSF rate reductions include coal transportation. The average revenue per ton-mile for coal declined 45% in inflation-adjusted dollars between 1981 and 1997. See Exhibit D. These rate declines have not been limited to coal shippers that have competitive options for service out of the Powder River Basin. All coal shippers are paying lower rates because of the productivity gains BNSF has achieved through massive investments in new capacity and new technologies.

BNSF has a strong incentive to keep rates to all shippers as low as possible. BNSF is in a partnership with its shippers to move as much traffic as possible. Even those utilities exclusively served by BNSF continue to be among the lowest cost generators of electricity in the nation. Several of BNSF's exclusively served plants are among the 100 lowest cost steam plants in the country. The variable costs of these plants range from 15% to 50% below the average variable costs for all coal-fired plants in the country. This railroad-utility partnership will become even more critical as electric utility deregulation accelerates and those customers begin to face increased competitive challenges in their own industry. BNSF will continue to work with those customers to provide the service and rate innovations they require as they move forward.

Competitive discipline on BNSF is provided not only by other rail carriers but also by motor, barge and pipeline carriers. Product and geographic competition restrain

many other markets. For instance, in the critical grain and coal markets, there is substantial downstream source competition that restrains the rates BNSF can charge. Export grain markets, for example, are extremely competitive and, if BNSF were to try to impose inappropriate rate increases, it would simply price itself out of the market. Thus, if one of our export grain shipper's prices are too high because our transportation rates are too high, then that shipper will be unable to participate in the export market, and both the shipper and we would lose that business opportunity.

Similarly, because electric utilities have multiple alternatives for acquiring the coal they need, the prices we can charge for transportation of coal to a particular location without losing the business altogether are strictly limited. That is all the more true since the advent of utility deregulation, which is forcing utilities to pursue such alternatives even more aggressively. In addition, the recent merger activity among electric utilities has created massive firms with negotiating leverage which can more than hold their own in negotiations involving rates to exclusively served plants. Further, the ICC/STB has acted to preserve existing competition for utilities in each of the rail merger and control transactions submitted for review.

III. Current Industry Problems Are Due to Insufficient Capacity and Forced Rail Access Would Not Remedy the Lack of Capacity.

As evidenced by the foregoing discussion, the ability of the railroad industry to maintain its financial stability and to increase capital investment in infrastructure is crucial to the continued strength, growth and competitiveness of the industry and to high quality service to shippers. This view is held not only by interested rail carriers. In fact, the

STB and shippers alike have reached this same conclusion and have expressed grave concerns about the current state of the rail infrastructure in the United States.

Most recently, the Railroad-Shipper Transportation Advisory Council ("RSTAC")^{12/} – an entity created by Congress to advise it, the Department of Transportation and the STB on the special concerns of small shippers and railroads, including car supply, rates and competition – concluded after analyzing the recent performance of rail services that the U.S. rail system has reached the point of being capacity constrained.^{13/} Specifically, the RSTAC found:

The serious railroad transportation problems experienced in 1997 throughout the United States prompted the RSTAC to analyze whether rail infrastructure continues to be capable of efficiently moving the volume of goods demanded by citizens. Our conclusion is that, due to a combination of factors, our rail system has reached a point of being capacity constrained.

RSTAC White Paper at 1 (emphasis added). Indeed, the RSTAC concluded that demands of shippers for competitive access are being driven by the insufficient capacity in the industry:

Ultimately, in our opinion, the issue of competitive access is really an issue of capacity and investment. The current lack of capacity, with the service disruptions that result, is the primary force behind a shipper's demand for access through "competition."

^{12/} The RSTAC is composed of fifteen non-government members, including representatives of shippers, meets at least twice a year and prepares an annual report to Congress. During the past two years, the Council has reviewed a number of issues and submitted several recommendations to Congress and the STB.

^{13/} See Railroad-Shipper Transportation Advisory Council, White Paper 1 (March 1998).

Id. at 4.

Similarly, the Board has found that "the infrastructure throughout the West may be growing increasingly incapable of handling growing traffic volumes"^{14/} and has cited the Houston area crisis as an example of what can occur when there is inadequate capital investment in infrastructure.^{15/} Noting that "the emergency [involving rail service in and around Houston] was not caused by an inadequate competitive climate", the STB concluded that, while "a variety of factors . . . may have contributed to the emergency, [the emergency was caused] in large measure by the inadequate infrastructure in the Houston area: the rail system in Houston has limited capacity, antiquated facilities and an inefficient configuration unable to cope with surges in demand."^{16/}

These persuasive findings by the Board and shipper interests show that today's rail industry still suffers from a lack of capacity. Insufficient capacity cannot, however, be remedied by forced rail access. Indeed, forced rail access would only exacerbate the capacity problems and would require massive reregulation of the rail industry. As recently observed by Secretary Slater, forced access to other carriers "could be operationally chaotic and could undermine the economic viability of the rail system."^{17/} Unless the current demand-based pricing structure is maintained, the opportunities for

^{14/} Service Order No. 1518, Decision (served Feb. 25, 1998) at fn. 7.

^{15/} Id. at 4-5.

^{16/} Id. at 4.

^{17/} "Slater: In His Own Words", 252 Traffic World, No. 5 at 17 (Nov. 3, 1997).

continued improvement in the rail industry infrastructure and service and safety improvements may be lost.

IV. Forced Rail Access Would Threaten the Industry's Ability to Remedy the Lack of Capacity and Continue Its Post-Staggers Performance.

Although implementation of the Staggers Act has reversed the long-term decline of the rail industry, the recovery is not complete. It is important that the trend toward full recovery not be interrupted and that previous gains in the financial health of the industry not be sacrificed. While returns on investment have shown improvement since 1980, the trend is punctuated from time to time by steep declines. See V.S. Anestis, Table IV. Moreover, even in peak years, the average return on investment is well below the cost of capital as determined by the ICC/STB. Id. From 1983 to 1995, industry returns ranged from 11% to 2.8% below the cost of capital. Id. For the average shareholder, this difference is critical. Further, from 1988 to 1995, the average return on equity for Class I railroads averaged almost 10% below the average for the S&P industrial index. See V.S. Anestis, Table V.

These facts provide a clear understanding of why the rate of railroad capital formation and infrastructure development has not kept pace with user needs and why, accordingly, there is a shortage of capacity in some parts of the country. While financial returns have improved dramatically since Staggers and investors are optimistic, returns are still inadequate. Returns below the cost of capital have not attracted sufficient capital to date. Nor will they in the future.

The problem of insufficient investment and undercapacity can only be remedied by adhering to policies that are sensitive to the needs and requirements of the investment community. Investors expect reasonable earnings and reasonable growth, and they rely on a stable and consistent regulatory environment.

Forced rail access would, however, undermine investor confidence and reverse the post-Staggers trend of improved earnings, enhanced financial stability and increased investment. Forced rail access would also increase regulatory uncertainty and market risk; it would undercut growth expectations and very likely reduce expected rail earnings. Each of these would, in turn, chill the enthusiasm of investors and drive their capital to other uses. Referring generally to proposals for forced access, the investment bankers have declared:

...regulatory changes of this type would discourage new investment in railroad infrastructure in a variety of ways. . . Most important, investors would be less willing to make funds available for costly infrastructure investments because of the uncertainty that [they] would generate competitive returns...Investor confidence [] would also decline...[and be] hurt because of concern over [] operating problems that would likely arise under the regime of forced access...[I]nvestors would be troubled by any changes in the regulatory structure that limit the ability of the railroads to price their services in accordance with demand.

V.S. Investment Bankers at 3-4.

Forced rail access would also reverse many of the network and system efficiencies brought about by the Staggers Act. The pre-Staggers regulatory scheme effectively compelled the railroads to operate numerous inefficient routes. They were

unable to concentrate traffic on the most efficient routes and gateways, and their ability to compete was diminished. Staggers reversed that system and allowed the railroads to invest in a streamlined and much more efficient and competitive network. Forced rail access would result in the breaking up of a nationwide network of single-line and run-through train service and efficient blocking in favor of a splintered, slower and less competitive service with inefficient car utilization and supply.

Proponents of forced rail access have pointed to the ongoing restructuring of the gas pipeline, electric transmission or telecommunications arenas. However, there are several significant differences between the rail industry and these other industries.

First, open access developed in the traditional utility industries because existing regulatory structures had failed to protect consumers. In particular, utilities were using their monopoly power in some areas, granted in many cases by federal and state law, to exercise monopoly powers in markets that otherwise would be competitive. Rates were far higher than market circumstances justified. Railroads by contrast do not have exclusive franchises granted by law from which to extend monopoly power, and the evidence discussed above clearly demonstrates that shippers are gaining the rate benefits of inter- and intramodal competition. Thus, the rationale for an open access regime does not exist in the railroad industry.

Second, there are major structural differences between the railroad industry and the gas, electric and telecommunications industries:

- Gas pipelines and electric transmission lines carry products that are completely fungible. A gas user does not care which molecule of gas it receives. In contrast, a railroad customer expecting chemicals will not be

satisfied with the delivery of coal, and an electric utility cannot use grain to generate electricity.

- Telecommunications messages, like rail traffic, are unique and not fungible. However, each message moves instantaneously and, in many respects, without combination with other messages. In contrast, railroad traffic must be batched, so that trains of optimal size are used. Furthermore, batched movement of unique goods must be scheduled on a coordinated basis. The industry could not function if individual cars were moved individually and without regard to competing demands for track usage. In addition, legislative efforts to mandate open access in telecommunications are currently mired in regulatory and legal uncertainty. Open access in telecommunications ultimately may or may not prove successful, but at the current time it is no model for other industries.

Accordingly, because railroad traffic is not fungible and must be batched, it is operationally very different from traditional utility services, and models applied to require separation of the natural monopoly services provided by utilities from competitive services which could be supplied by anyone do not apply to the railroad industry.

Third, some commentators point to open access rail regimes in other countries. However, in almost all cases, those regimes involve the transition from state-owned monopolies to privatization, with ownership of the rails centralized in a single entity. In the United States, the industry already is in private ownership, and forced rail access would involve de facto or de jure nationalization of assets.

Fourth, the Board should understand the costs of open access in the utility industry. Regulators prescribe rates, terms and conditions of service, and even business practices. They determine the internal structure of corporations in separating competitive from monopoly services. They establish the method for recovering costs that are "stranded" in the transition to open access. In the gas industry, the Federal Energy Regulatory Commission even defines the electronic forms used for business. Thus,

under a system of forced rail access, the Board would have to reinject itself into the ratemaking process, establish the priorities for and the terms and conditions for allocating rights to use track, and, in short, reverse the deregulatory direction of the Staggers Act and the progress made thereunder.

Further, the open access process in the utility industries has been costly and lengthy. Full open access in the natural gas pipeline industry took fifteen years to implement after passage of the Natural Gas Policy Act of 1978 and is still a work in progress at the retail level. The first legislative efforts to create open access in the electric industry failed, and open access there similarly remains a work in progress. The current controversies surrounding the Telecommunications Act of 1996 also reflect the pitfalls of restructuring an industry.

In short, utility open access is a model imposed upon industries with fundamentally different operating characteristics than railroads in order to respond to problems that do not exist in the railroad industry. When the need of railroads both to deliver unique goods on a batched basis using limited capacity and to attract adequate capital is recognized, it is evident that forced rail access is shorthand for a return to regulatory models that failed in the past. Forced open access would both exacerbate the problems caused by the current insufficient capacity and undercut the success achieved by regional and shortline carriers in keeping branch lines operative and in preserving rail service to shippers on those lines. This is not the time to undo almost twenty years of steady progress.

As a matter of public policy, therefore, the railroad industry and its customers do not need to go through another massive restructuring. As an economic matter, they cannot afford to do so. The Staggers Act struck the proper balance between shippers' needs for competitive rates and more reliable service and the railroads' needs to generate adequate revenue to attract capital to maintain and expand their infrastructure.

V. Shippers' Interests are Protected in the Current Rail Industry Structure.

Congress and the ICC/STB recognized that the shift to a demand-based pricing system required the adoption of measures designed to protect shippers. Protections are afforded when competition is found to be inadequate or there is a risk that market power will be abused.

In addition to each rail carrier's common carrier obligation to serve shippers, the Staggers Act provided and the STB has implemented a mechanism for determining maximum reasonable rates for shippers where a rail carrier is "market dominant." Likewise, the STB's competitive access regulations enable a shipper to secure access to a second carrier if it is shown that the existing carrier has abused its market power through its rates or service. In response to shippers' complaints that the existing procedures were too cumbersome, complex and costly, Congress required as part of the ICCTA the establishment of simplified and streamlined procedures for rate challenges. Thus, on October 1, 1996, the STB issued final rules establishing such procedures in Expedited Procedures for Processing Rail Rate Reasonableness, Exemption and Revocation Proceedings, Ex Parte No. 527 (Sub-No. 1) (STB served Oct. 1, 1996), for cases adjudicated under the Constrained Market Pricing standard. Thereafter, the STB

issued final rules on January 16, 1998, for rate complaints using the simplified maximum rate guidelines which had been adopted in Rate Guidelines -- Non-Coal Proceedings, Ex Parte No. 347 (Sub-No. 2) (STB served Dec. 31, 1996), for small shippers and other cases where the amount involved would not justify a full stand-alone cost presentation. These rules are intended to protect shippers from paying unnecessarily high rates while fairly rewarding carriers for the expense and risk they assume in providing service and the investment they make in rail facilities.

The ICC/STB has taken a balanced, even-handed approach to dealing with rate reasonableness challenges. For instance, while BNSF prevailed in the McCarty Farms proceeding,^{18/} BNSF was ordered to provide rate relief and to pay \$40 million in reparations in the Arizona Public Service and West Texas Utilities proceedings.^{19/} The recent FMC "bottleneck" case^{20/} involving Union Pacific is another example where the shipper was afforded relief.

As for service protections, the emergency service order provisions of the ICCTA enable the STB to act when shippers do not receive adequate service. Recently, the STB issued an emergency service order to address service problems in the Houston area in response to shippers' complaints. STB Service Order No. 1518 -- Joint Petition

^{18/} McCarty Farms, Inc., et al. v. Burlington Northern, Inc., Docket No. 37809 (STB served Aug. 20, 1997).

^{19/} Arizona Public Service Co., et al. v. The Atchison, Topeka and Santa Fe Railway Co., Docket No. 41185 (STB served July 29, 1997); West Texas Utilities Co. v. Burlington Northern Railroad Co., Docket No. 41191 (STB served May 3, 1996).

^{20/} FMC Wyoming Corp., et al. v. Union Pacific Railroad Co., Finance Docket No. 33467 (STB served Dec. 16, 1997).

for Service Order (served October 31, 1997). In addition, shippers have remedies available to them for recovery of damages caused by inadequate service for both contract and common carrier traffic.

Competition among the rail carriers is also preserved by ICC/STB review of rail merger and control transactions. The ICC/STB has exercised its authority to impose significant pro-competitive conditions on many of those transactions. Indeed, the STB imposed conditions on the two most recent Class I merger transactions, the Burlington Northern and The Atchison, Topeka and Santa Fe transaction and the Union Pacific and Southern Pacific transaction. The ICC denied the ATSF/SP transaction outright.

Thus, the current statutory and regulatory structure protects shippers from abuse of market power by the railroads, and recent experience also demonstrates that service issues can be effectively addressed by the STB in the administrative arena.

VI. Potential Modifications to Existing Protections.

While BNSF believes that it is of critical importance to maintain a demand-based pricing structure and that the existing statutory and regulatory protections provide shippers with adequate protection, we recognize that some have expressed concerns about the effectiveness of existing statutory and regulatory opportunities to seek relief from rate and service problems. In particular, shippers have claimed that they cannot obtain relief in a timely manner and that the procedures for obtaining relief are too difficult and cumbersome. In order to address those concerns, the STB may want to consider establishing an advisory committee to undertake a negotiated rulemaking to identify and address specific shipper concerns about cumbersome procedures. Such an

approach would enable the STB to consider proposals for action that have been developed by the parties in a negotiated, consultative context rather than in the context of a potentially adversarial, traditional regulatory proceeding. Among the possible areas for Board consideration are:

- The STB could require railroads and shipper organizations to meet periodically to forecast and plan, for example, for peak agricultural demand periods so that the railroads can better serve shipper needs.
- The STB could require railroads to report periodically on their responsiveness to shippers' concerns and needs.
- The STB could require railroads to provide improved advance notification of major and long-term service changes so that shippers could plan their shipping and delivery cycles in order to better accommodate those changes.
- The STB could reduce the required showing for relief for service-related problems under the competitive access rules or the emergency service order rules.

In addition, we support the use by the STB of more expeditious procedures for handling all rate reasonable proceedings and the elimination of as many regulatory and administrative hindrances to the prompt and efficient resolution of such challenges as possible.

CONCLUSION

In conclusion, it is BNSF's view that the current demand-based or differential pricing system is functioning well and as anticipated by Congress when it adopted the Staggers Act. Any fundamental changes in the existing structure would necessarily imperil the service and safety achievements that have been reached, would restrict the rail industry's ability to compete with other modes of transportation, and would inhibit the capital investment that will be required to maintain and increase the capacity of the domestic rail system so that shippers' needs can be met reliably and efficiently. Forced rail access would both exacerbate the problems caused by the current insufficient capacity and undercut the success achieved by regional and shortline carriers in keeping branch lines operative and in preserving rail service to shippers on those lines. A return to a pre-Staggers Act style of regulation would bring with it all of the pitfalls and weaknesses Congress sought to remedy with that Act and would undercut the revitalization of the industry in the post-Act era. BNSF would, however, be willing to join with the Board and the shipping community to meet to address and reach appropriate solutions to the concerns that have been raised.

Respectfully submitted,

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March 26, 1998

CERTIFICATE OF SERVICE

I hereby certify that a copy of the foregoing Comments of The Burlington Northern and Santa Fe Railway Company on Rail Access and Competition was served, by first-class mail, postage prepaid, or by a more expeditious manner of delivery, on this 26th day of March, 1998, on all Parties of Record in the Ex Parte No. 575 proceeding.

Adam J. Pelt. Jr.

EXHIBIT A

BURLINGTON NORTHERN AND SANTA FE RAILWAY COMPANY
(Incl. AT&SF, C&S, FW&D and FRISCO)

LINE	DESCRIPTION	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987
527	Avg. miles of road operated (freight)	41,164	41,032	39,884	41,460	41,136	40,136	38,517	36,640	37,200	35,100
528	Total carloads originated	3,543,314	3,817,469	3,965,903	3,603,607	3,603,661	3,725,468	4,158,746	3,877,262	3,832,482	4,732,189
529	Total tons originated	824,632,149	856,273,073	893,468,087	820,893,087	862,194,028	871,717,086	904,628,077	878,870,324	877,600,143	924,341,147
530	Revenue tons carried (000)	361,554	362,880	404,749	429,088	329,845	335,268	368,976	339,712	338,485	390,001
531	Gross ton-miles (incl. loco.) (000)	424,826,818	489,227,170	484,180,522	488,852,823	443,574,485	470,339,034	828,125,013	483,469,017	483,808,911	531,412,411
532	Train - miles	101,608,648	106,082,063	110,801,891	107,634,664	96,632,312	83,546,878	101,868,016	85,766,707	96,500,618	107,976,148
709	Revenue ton-miles (000)	188,848,248	224,470,010	244,008,884	250,682,682	228,005,924	240,091,761	275,669,318	253,166,565	254,325,189	278,301,686
	BNSF	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997
527	Avg. miles of road operated (freight)	35,128	34,822	33,682	32,727	31,500	30,617	30,503	31,268	35,170	33,855
528	Total carloads originated	4,826,812	4,838,123	5,053,782	5,019,985	5,184,442	5,337,618	5,788,750	5,987,408	5,863,518	6,118,602
529	Total tons originated	311,488,086	322,448,600	336,880,594	335,034,484	346,794,460	346,584,678	385,888,988	386,423,480	381,706,625	384,883,197
530	Revenue tons carried (000)	375,091	398,633	408,570	409,157	414,328	422,386	451,908	482,404	468,740	487,537
531	Gross ton-miles (incl. loco.) (000)	828,680,344	983,304,437	972,678,213	984,911,183	970,288,170	408,988,111	638,543,385	883,800,623	680,271,727	776,334,498
532	Train - miles	110,350,012	118,092,229	114,370,602	110,044,753	112,718,178	114,017,620	123,180,267	126,830,261	128,057,134	143,935,338
709	Revenue ton-miles (000)	300,822,647	315,288,804	312,220,441	313,877,041	318,428,764	330,482,828	380,605,000	397,901,500	414,451,874	428,843,743
	BNSF	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997

Cumulative % Change

	78-87	88-97	98-97
527	-18%	-10%	-4%
528	75%	61%	32%
529	64%	42%	24%
530	29%	30%	25%
531	83%	63%	47%
532	42%	54%	30%
709	116%	70%	43%

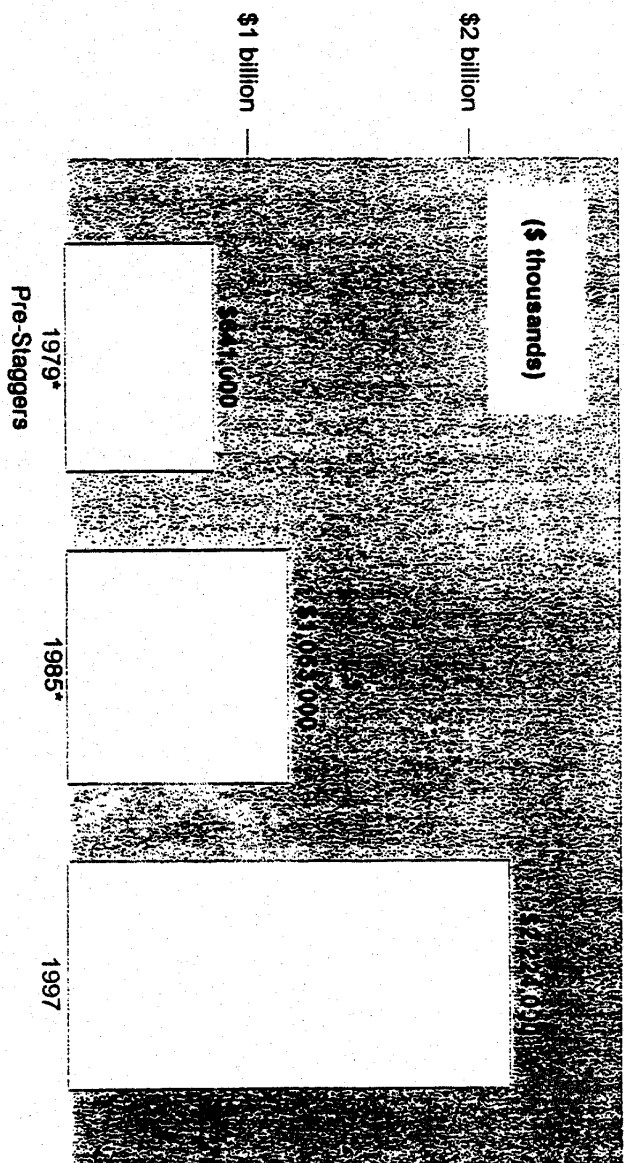
EXHIBIT B

BURLINGTON NORTHERN AND SANTA FE RAILWAY COMPANY

LINE	DESCRIPTION	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996
323	BHP/PO FORM																			
324	Capital Expenditures	116,643	115,326	115,399	115,778	121,180	86,852	88,277	112,157	115,336	115,845	131,643	121,810	144,170	131,643	131,643	144,170	144,170	144,170	144,170
325	Plant	116,643	115,326	115,399	115,778	121,180	86,852	88,277	112,157	115,336	115,845	131,643	121,810	144,170	131,643	131,643	144,170	144,170	144,170	144,170
326	Equipment	116,643	115,326	115,399	115,778	121,180	86,852	88,277	112,157	115,336	115,845	131,643	121,810	144,170	131,643	131,643	144,170	144,170	144,170	144,170
327	Other	116,643	115,326	115,399	115,778	121,180	86,852	88,277	112,157	115,336	115,845	131,643	121,810	144,170	131,643	131,643	144,170	144,170	144,170	144,170
328	Other	116,643	115,326	115,399	115,778	121,180	86,852	88,277	112,157	115,336	115,845	131,643	121,810	144,170	131,643	131,643	144,170	144,170	144,170	144,170
329	Other	116,643	115,326	115,399	115,778	121,180	86,852	88,277	112,157	115,336	115,845	131,643	121,810	144,170	131,643	131,643	144,170	144,170	144,170	144,170
330	Other	116,643	115,326	115,399	115,778	121,180	86,852	88,277	112,157	115,336	115,845	131,643	121,810	144,170	131,643	131,643	144,170	144,170	144,170	144,170
331	Other	116,643	115,326	115,399	115,778	121,180	86,852	88,277	112,157	115,336	115,845	131,643	121,810	144,170	131,643	131,643	144,170	144,170	144,170	144,170
332	Other	116,643	115,326	115,399	115,778	121,180	86,852	88,277	112,157	115,336	115,845	131,643	121,810	144,170	131,643	131,643	144,170	144,170	144,170	144,170
333	Other	116,643	115,326	115,399	115,778	121,180	86,852	88,277	112,157	115,336	115,845	131,643	121,810	144,170	131,643	131,643	144,170	144,170	144,170	144,170
334	Other	116,643	115,326	115,399	115,778	121,180	86,852	88,277	112,157	115,336	115,845	131,643	121,810	144,170	131,643	131,643	144,170	144,170	144,170	144,170
335	Other	116,643	115,326	115,399	115,778	121,180	86,852	88,277	112,157	115,336	115,845	131,643	121,810	144,170	131,643	131,643	144,170	144,170	144,170	144,170
336	Other	116,643	115,326	115,399	115,778	121,180	86,852	88,277	112,157	115,336	115,845	131,643	121,810	144,170	131,643	131,643	144,170	144,170	144,170	144,170
337	Other	116,643	115,326	115,399	115,778	121,180	86,852	88,277	112,157	115,336	115,845	131,643	121,810	144,170	131,643	131,643	144,170	144,170	144,170	144,170
338	Other	116,643	115,326	115,399	115,778	121,180	86,852	88,277	112,157	115,336	115,845	131,643	121,810	144,170	131,643	131,643	144,170	144,170	144,170	144,170
339	Other	116,643	115,326	115,399	115,778	121,180	86,852	88,277	112,157	115,336	115,845	131,643	121,810	144,170	131,643	131,643	144,170	144,170	144,170	144,170
340	Other	116,643	115,326	115,399	115,778	121,180	86,852	88,277	112,157	115,336	115,845	131,643	121,810	144,170	131,643	131,643	144,170	144,170	144,170	144,170
341	Other	116,643	115,326	115,399	115,778	121,180	86,852	88,277	112,157	115,336	115,845	131,643	121,810	144,170	131,643	131,643	144,170	144,170	144,170	144,170
342	Other	116,643	115,326	115,399	115,778	121,180	86,852	88,277	112,157	115,336	115,845	131,643	121,810	144,170	131,643	131,643	144,170	144,170	144,170	144,170
343	Other	116,643	115,326	115,399	115,778	121,180	86,852	88,277	112,157	115,336	115,845	131,643	121,810	144,170	131,643	131,643	144,170	144,170	144,170	144,170
344	Other	116,643	115,326	115,399	115,778	121,180	86,852	88,277	112,157	115,336	115,845	131,643	121,810	144,170	131,643	131,643	144,170	144,170	144,170	144,170
345	Other	116,643	115,326	115,399	115,778	121,180	86,852	88,277	112,157	115,336	115,845	131,643	121,810	144,170	131,643	131,643	144,170	144,170	144,170	144,170
346	Other	116,643	115,326	115,399	115,778	121,180	86,852	88,277	112,157	115,336	115,845	131,643	121,810	144,170	131,643	131,643	144,170	144,170	144,170	144,170
347	Other	116,643	115,326	115,399	115,778	121,180	86,852	88,277	112,157	115,336	115,845	131,643	121,810	144,170	131,643	131,643	144,170	144,170	144,170	144,170
348	Other	116,643	115,326	115,399	115,778	121,180	86,852	88,277	112,157	115,336	115,845	131,643	121,810	144,170	131,643	131,643	144,170	144,170	144,170	144,170
349	Other	116,643	115,326	115,399	115,778	121,180	86,852	88,277	112,157	115,336	115,845	131,643	121,810	144,170	131,643	131,643	144,170	144,170	144,170	144,170
350	Other	116,643	115,326	115,399	115,778	121,180	86,852	88,277	112,157	115,336	115,845	131,643	121,810	144,170	131,643	131,643	144,170	144,170	144,170	144,170
351	Other	116,643	115,326	115,399	115,778	121,180	86,852	88,277	112,157	115,336	115,845	131,643	121,810	144,170	131,643	131,643	144,170	144,170	144,170	144,170
352	Other	116,643	115,326	115,399	115,778	121,180	86,852	88,277	112,157	115,336	115,845	131,643	121,810	144,170	131,643	131,643	144,170	144,170	144,170	144,170
353	Other	116,643	115,326	115,399	115,778	121,180	86,852	88,277	112,157	115,336	115,845	131,643	121,810	144,170	131,643	131,643	144,170	144,170	144,170	144,170
354	Other	116,643	115,326	115,399	115,778	121,180	86,852	88,277	112,157	115,336	115,845	131,643	121,810	144,170	131,643	131,643	144,170	144,170	144,170	144,170
355	Other	116,643	115,326	115,399	115,778	121,180	86,852	88,277	112,157	115,336	115,845	131,643	121,810	144,170	131,643	131,643	144,170	144,170	144,170	144,170
356	Other	116,643	115,326	115,399	115,778	121,180	86,852	88,277	112,157	115,336	115,845	131,643	121,810	144,170	131,643	131,643	144,170	144,170	144,170	144,170
357	Other	116,643	115,326	115,399	115,778	121,180	86,852	88,277	112,157	115,336	115,845	131,643	121,810	144,170	131,643	131,643	144,170	144,170	144,170	144,170
358	Other	116,643	115,326	115,399	115,778	121,180	86,852	88,277	112,157	115,336	115,845	131,643	121,810	144,170	131,643	131,643	144,170	144,170	144,170	144,170
359	Other	116,643	115,326	115,399	115,778	121,180	86,852	88,277	112,157	115,336	115,845	131,643	121,810	144,170	131,643	131,643	144,170	144,170	144,170	144,170
360	Other	116,643	115,326	115,399	115,778	121,180	86,852	88,277	112,157	115,336	115,845	131,643	121,810	144,170	131,643	131,643	144,170	144,170	144,170	144,170
361	Other	116,643	115,326	115,399	115,778	121,180	86,852	88,277	112,157	115,336	115,845	131,643	121,810	144,170	131,643	131,643	144,170	144,170	144,170	144,170
362	Other	116,643	115,326	115,399	115,778	121,180	86,852	88,277	112,157	115,336	115,845	131,643	121,810	144,170	131,643	131,643	144,170	144,170	144,170	144,170
363	Other	116,643	115,326	115,399	115,778	121,180	86,852	88,277	112,157	115,336	115,845	131,643	121,810	144,170	131,643	131,643	144,170	144,170	144,170	144,170
364	Other	116,643	115,326	115,399	115,778	121,180	86,852	88,277	112,157	115,336	115,845	131,643	121,810	144,170	131,643	131,643	144,170	144,170	144,170	144,170
365	Other	116,643	115,326	115,399	115,778	121,180	86,852	88,277	112,157	115,336	115,845	131,643	121,810	144,170	131,643	131,643	144,170	144,170	144,170	144,170
366	Other	116,643	115,326	115,399	115,778	121,180	86,852	88,277	112,157	115,336	115,845	131,643	121,810	144,170	131,643	131,643	144,170	144,170	144,170	144,170
367	Other	116,643	115,326	115,399	115,778	121,180	86,852	88,277	112,157	115,336	115,845	131,643	121,810	144,170	131,643	131,643	144,170	144,170	144,170	144,170
368	Other	116,643	115,326	115,399	115,778	121,180	86,852	88,277	112,157	115,336	115,845	131,643	121,810	144,170	131,643	131,643	144,170	144,170	144,170	144,170
369	Other	116,643	115,326	115,399	115,778	121,180	86,852	88,277	112,157	115,336	115,845	131,643	121,810	144,170	131,643	131,643	144,170	144,170	144,170	144,170
370	Other	116,643	115,326	115,399	115,778	121,180	86,852	88,277	112,157	115,336	115,845	131,643	121,810	144,170	131,643	131,643	144,170	144,170	144,170	144,170
371	Other	116,643	115,326	115,399	115,778	121,180	86,852	88,277	112,157	115,336	115,845	131,643	121,810	144,170	131,643	131,643	144,170	144,170	144,170	144,170
372	Other	116,643	115,326	115,399	115,778	121,180	86,852	88,277	112,157	115,336	115,845	131,643	121,810	144,170	131,643	131,643	144,170	144,170	144,170	144,170
373	Other	116,643	115,326	115,399	115,778	121,180	86,852	88,277	112,157	115,336	115,845	131								

EXHIBIT C

BNSF Capital Investments



*BNSF predecessor railroads

Burlington Northern Santa Fe
Capital Expenditures
1988 - 1975
(\$ 000)

Consolidated BNSF													
	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987
Tree	218,750	194,915	230,643	161,736	163,713	127,199	144,636	110,131	113,370	113,900	63,165	88,776	120,508
Rail & other track materials	208,238	483,075	522,651	395,631	313,062	231,288	222,801	187,817	146,894	135,624	121,241	151,590	170,627
Buildings	82,696	179,123	180,211	144,404	134,949	110,280	82,520	83,848	117,177	80,871	84,043	88,007	112,040
Other Road	21,815	827,854	587,448	387,002	477,971	287,286	140,887	222,065	223,176	181,204	150,879	127,129	151,556
Terminal and Line Expansion (a)	497,200												
Total Road Expenditures	1,758,960	1,384,867	1,533,653	1,008,673	1,086,595	758,313	660,173	662,836	571,317	550,399	452,348	485,504	554,137
Locomotives													
Leased Locomotive Overhead (b)	437,003	972,100	320,717	197,113	230,413	131,295	32,699	142,820	220,955	70,160	65,081	38,351	76,828
Freight Cars	37,418	29,525	57,429	20,086	48,714	108,683	35,798	45,175	17,918	8,222	48,482	20,741	10,385
Other Equipment	48,220	48,080	137,429	113,817	110,405	109,079	90,784	58,442	25,766	41,183	64,803	56,017	29,081
Total Equipment	540,311	1,049,705	505,575	310,917	389,532	349,057	118,281	244,537	244,537	119,565	188,466	115,107	115,771
Other Expenditures (c)	28,309	22,464	216,152	120,100	(82,047)	97,218	34,654	31,818	(14,318)	6,794	36,702	(18,122)	(16,844)
Total Capital Expenditures	\$3,061,080	\$3,120,861	\$3,318,363	\$1,564,746	\$1,418,627	\$1,260,246	\$724,966	\$839,415	\$822,897	\$647,126	\$797,486	\$561,481	\$653,891

Source: R-1a - Schedule 320 plus BN Leasing and Leased Locomotive Overhead.
Note: 1983 and forward represents Depreciation accounting with 1982: 1975 represents Retention, 1982: 1975 represents Retention, 1982: 1975 represents Retention.
(a) Terminal and Line Expansion costs for all years other than 1988 are included with Tree.
(b) Leased Locomotive Overhead are included for 1985-1987 due to a change in accounting method upon merger. 1988 capital is included in the Locomotive line.
(c) Other Expenditures is primarily made up of the change in the Construction in Process account -- For years 1986-1987 represents combined BNSF Railway.

EXHIBIT D

BNSF Freight Revenue Per Ton-Mile		
Year	Current (Cents per ton-mile)	1981 Constant (Cents per ton-mile)
1981	2.42	2.42
1982	2.68	2.53
1983	2.62	2.39
1984	2.55	2.24
1985	2.53	2.14
1986	2.35	1.95
1987	2.28	1.82
1988	2.31	1.78
1989	2.30	1.69
1990	2.27	1.58
1991	2.24	1.50
1992	2.24	1.45
1993	2.23	1.40
1994	2.11	1.29
1995	2.13	1.27
1996	2.10	1.22
1997	2.12	1.20

COAL Freight Revenue Per Ton-Mile		
Year	Current (Cents per ton-mile)	1981 Constant (Cents per ton-mile)
1981	1.23	1.23
1982	1.57	1.48
1983	1.66	1.51
1984	1.69	1.48
1985	1.63	1.38
1986	1.46	1.21
1987	1.46	1.17
1988	1.49	1.15
1989	1.46	1.07
1990	1.42	0.99
1991	1.43	0.95
1992	1.40	0.91
1993	1.35	0.85
1994	1.30	0.80
1995	1.25	0.75
1996	1.20	0.70
1997	1.20	0.68

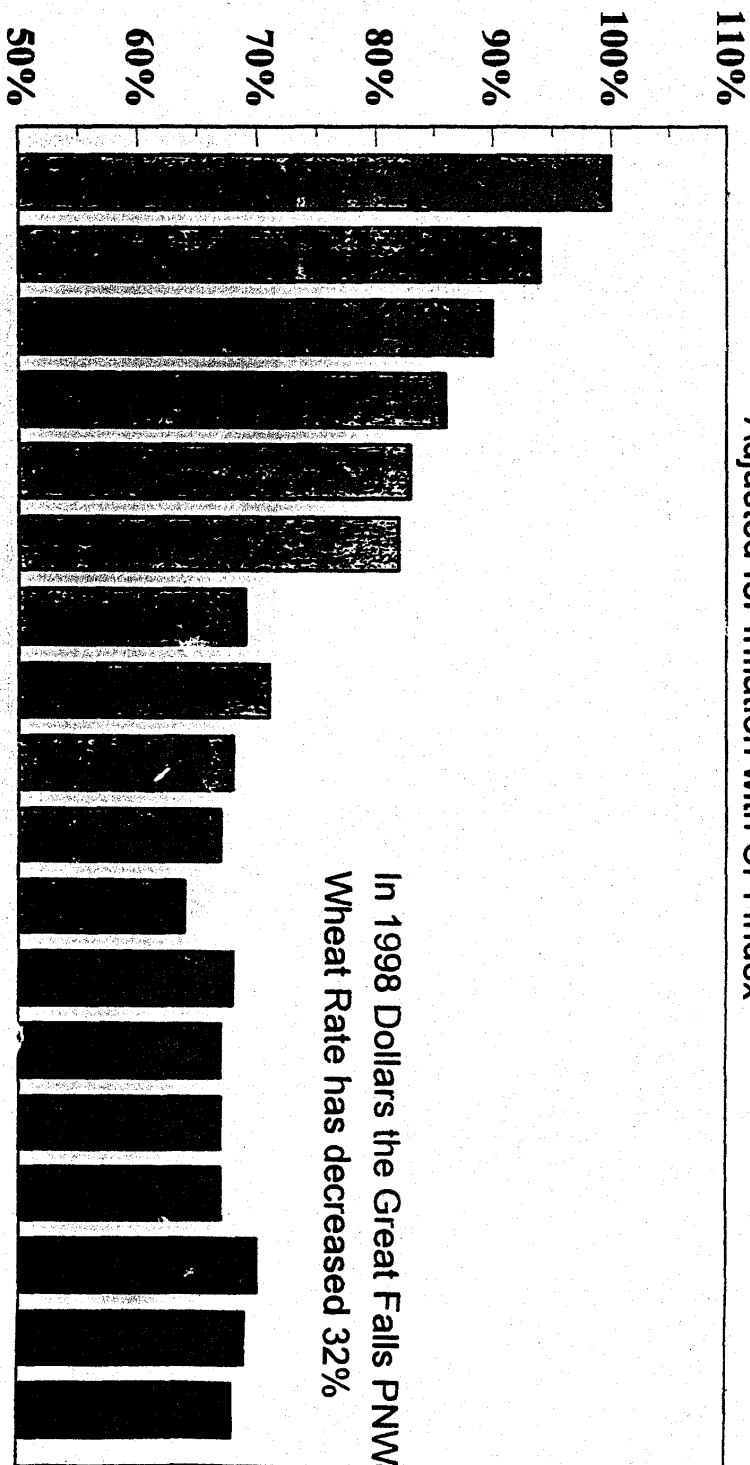
AG COMMODITIES Freight Revenue Per Ton-Mile		
Year	Current (Cents per ton-mile)	1981 Constant (Cents per ton-mile)
1981	2.70	2.70
1982	2.74	2.58
1983	2.42	2.20
1984	2.24	1.96
1985	2.47	2.08
1986	2.09	1.74
1987	1.75	1.40
1988	1.93	1.48
1989	1.94	1.42
1990	2.09	1.45
1991	2.08	1.39
1992	2.13	1.38
1993	2.21	1.39
1994	2.24	1.37
1995	2.04	1.22
1996	2.09	1.21
1997	2.10	1.19

ALL OTHER Freight Revenue Per Ton-Mile		
Year	Current (Cents per ton-mile)	1981 Constant (Cents per ton-mile)
1981	3.49	3.49
1982	4.06	3.33
1983	4.01	3.66
1984	3.85	3.37
1985	3.60	3.04
1986	3.37	2.80
1987	3.10	2.48
1988	3.17	2.43
1989	3.13	2.29
1990	3.08	2.15
1991	2.99	1.99
1992	2.96	1.92
1993	2.97	1.87
1994	2.78	1.71
1995	2.98	1.78
1996	2.95	1.71
1997	2.93	1.66

Note: Constant dollar figures are derived using the CPI

EXHIBIT E

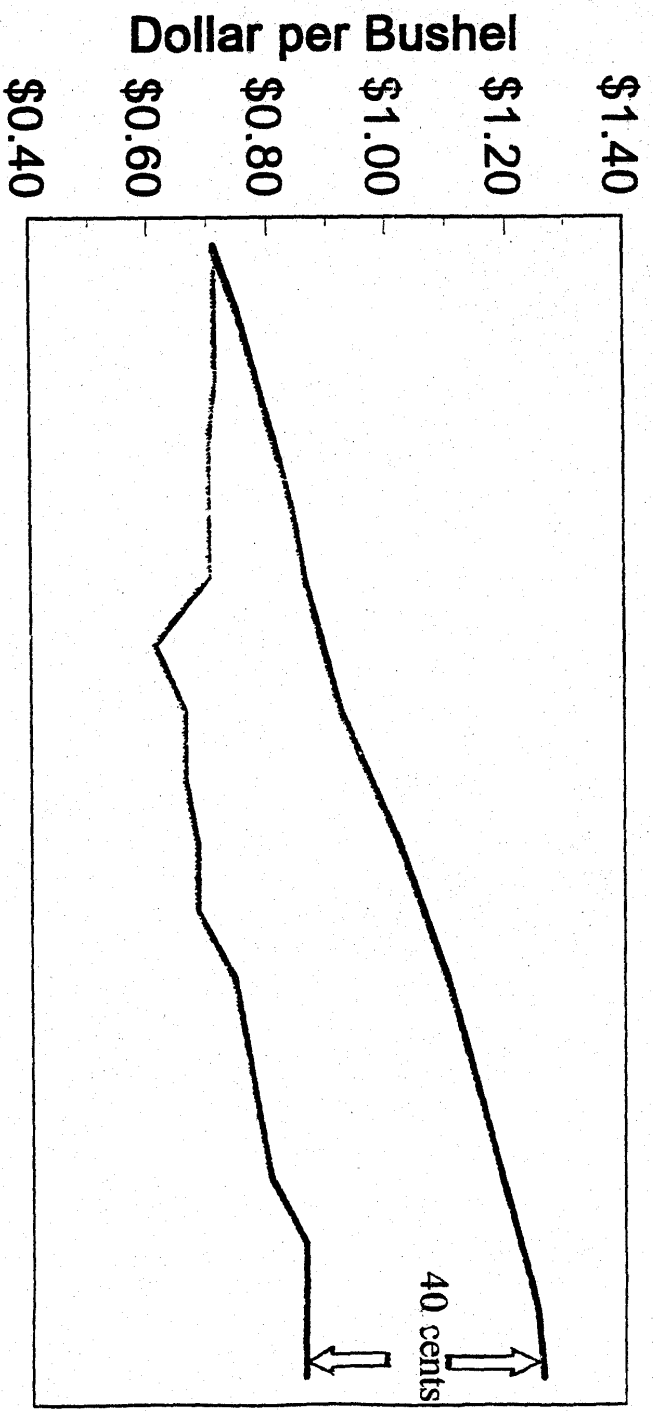
Adjusted for Inflation with CPI Index



	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998
52 Car Rate	100%	94%	90%	86%	83%	82%	69%	71%	68%	67%	64%	68%	67%	67%	67%	70%	69%	68%

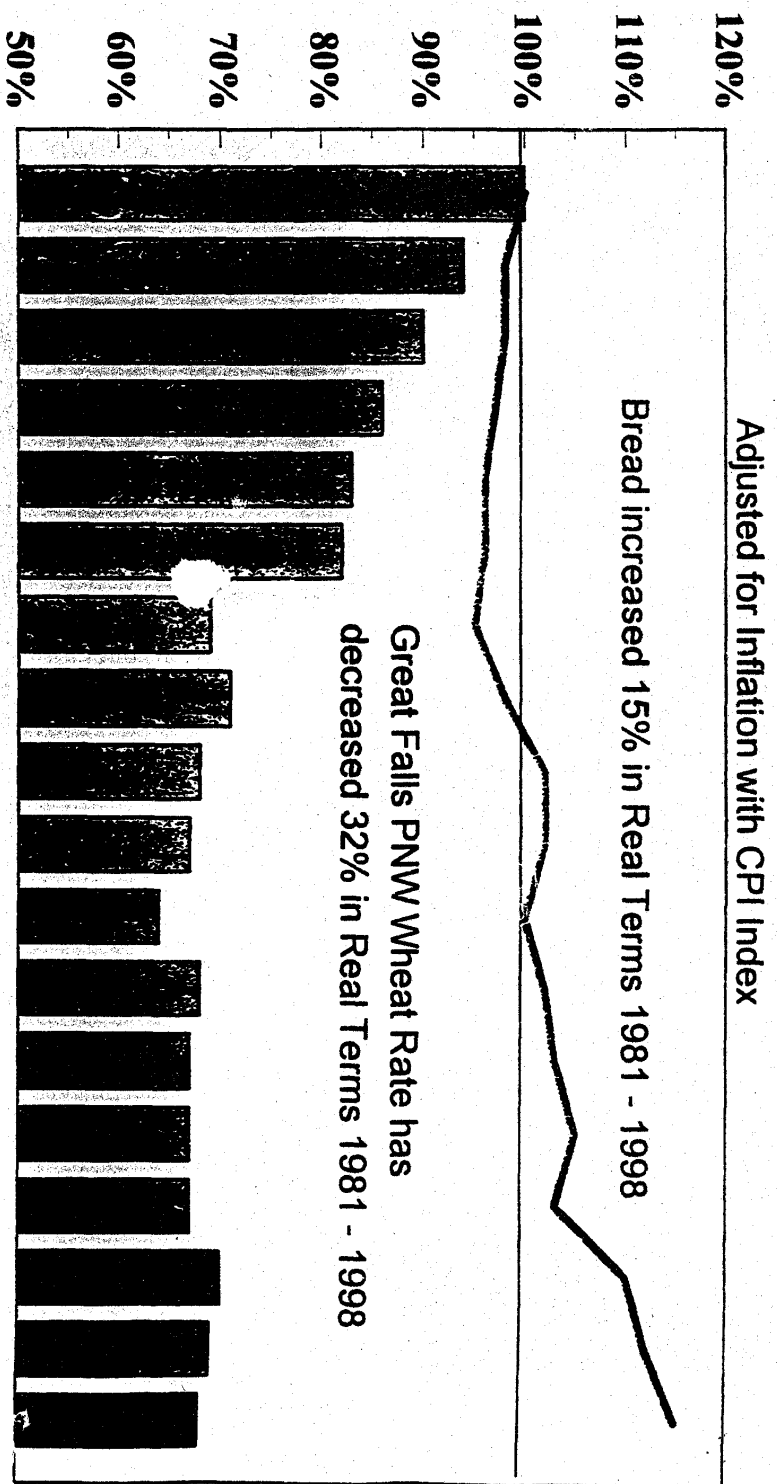
Inflation Adjusted Rate calculated utilizing Consumer Price Index (CPI) factor

Montana 52 Car PNW Wheat Rates



Inflation Adjusted Rate calculated utilizing Consumer Price Index (CPI) factor multiplied by rates in base year of 1981

MONTANA 52 CAR PNW WHEAT RATES vs 1 LB LOAF OF BREAD



	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998
52 Car Rate	100%	94%	90%	86%	83%	82%	69%	71%	68%	67%	64%	68%	67%	67%	67%	70%	69%	68%
Bread	100%	98%	98%	97%	96%	96%	95%	98%	102%	102%	100%	102%	103%	105%	103%	110%	112%	115%

Inflation Adjusted Rate calculated utilizing Consumer Price Index (CPI) factor
Wheat rates from BNSF Tariff, Bread Prices and CPI Index from Bureau of Labor Statistics